Tel: 416 865 0200
Fax: 416 865 0887
www.bdo.ca

BDO Canada LLP
TD Bank Tower
66 Wellington Street West,
Suite 3600, P.O. Box 131
Toronto, ON M5K 1H1 Canada

CONSULTATION: TAX PLANNING USING PRIVATE CORPORATIONS

BDO CANADA LLP's RESPONSE TO THE DEPARTMENT OF FINANCE CANADA

This submission represents the views and suggestions of BDO Canada LLP ("BDO") with respect to the Department of Finance Canada's consultation paper "Tax Planning Using Private Corporations", released on July 18, 2017. As the leading professional firm in the Canadian market providing tax services to Canadian private businesses, and the families and individuals owning these businesses, we believe we have unique insight into this important segment of the Canadian economy, the challenges they face, and the type of tax policies that we as a country need to properly support entrepreneurism in Canada.

This submission was developed in consultation with our tax professionals from our 140 offices across Canada, covering the entire Canadian landscape. They bring a unique insight into the Canadian tax system and how it impacts Canadian private business from coast to coast. Our submission also takes into account feedback we have received from hundreds of our clients. We service thousands of businesses and individuals in Canada and we have heard from many of them on these proposals.

Our submission will focus first on our overarching concerns with the July 18th proposals, followed by our views and suggestions for each of the three key issues covered in the paper.

What Canada Needs With Respect to Tax Policy

On November 1, 2016, Bruce Ball, who was BDO's National Tax Office Partner at the time, appeared before the Senate Standing Committee on National Finance and expressed the need for a comprehensive tax review of Canadian tax law before any additional tax measures were introduced or changed. He highlighted three key reasons for a review:

- Canada's tax system had not had a thorough review since the Royal Commission in 1966;
- Canada's tax code in overly complex; and
- There is widespread support for tax reform.

In its report presented to Parliament on December 7, 2016, the House of Commons Standing Committee on Finance chaired by the Honourable Wayne Easter agreed with Mr. Ball. The Committee's report called for a comprehensive review of the Income Tax Act in consideration of simplifying the tax rules.

BDO agreed with and continues to agree with these objectives. Canada needs tax reform to create a tax system that both helps Canadian businesses grow and thrive, while at the same time being fair to all Canadians. We have been and continue to be willing to work with the Canadian government, Canadian business and all relevant stakeholders in helping to make this a reality.

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BDO's Reaction to the July 18, 2017 Consultation Paper

BDO has been disappointed with the overall approach of the consultation paper that was released on July 18, 2017. Following are the reasons for our concerns:

1. The measures were released in a manner that clearly targets what the government believes to be specific unfair tax policies, without an appropriate review of the impact of the proposals on businesses and families and what would be appropriate tax policy to support the Canadian business community. We would strongly recommend a comprehensive review of the Canadian tax system, done in consultation with all relevant stakeholders.
2. Two of the three key issues that were part of the paper were accompanied by detailed draft legislation outlining what the government intends to do. This is a clear indication that the government appears not really interested in any meaningful consultation on the proposals. This is supported by the fact that the consultation period for these measures is only 75 days, with the majority of that consultation period occurring in the summer months when thousands of Canadians take their well-deserved vacation time with family.
3. The government is proposing to change tax policies that have been clear and, in many cases, in effect for decades. This type of change should only be done as part of a comprehensive tax reform, not with changes to the law to target perceived abuses.
4. The language the government chose to use in the July 18, 2017 release, and continues to use to convince Canadians of the need for change, is inappropriate. The language suggests that the wealthiest Canadians are unfairly exploiting the tax "loopholes", when in fact, Canadian businesses at all income levels have been arranging their affairs and managing their tax cost within Canadian tax rules that are legislated and have been clear.
5. The government has indicated that these proposals do not impact Canadians who earn less than $150,000. We respectfully disagree with this assessment. These proposals will impact all Canadian businesses and the families behind them, at all income levels. We have included a simple example in Appendix 1 that demonstrates that lower income businesses are impacted.
6. We believe the proposals are worded in such a manner that they will cause many forms of transactions to be impacted that the government did not intend to include in these measures.
7. The proposals and accompanying draft legislation are extremely complex. They do not help at all in bringing either certainty or simplification to Canadian tax law, two key objectives in creating the right investment climate for the Canadian economy. The proposals, in our view, do the opposite and they will place additional burden on Canadian businesses.
8. Some of the measures are retroactive in nature. This falls short of what we believe should be the goal of any changes to Canadian tax law – certainty and fairness.

We agree that the government has certain valid concerns that motivated it to introduce these changes. There are always situations where a taxpayer has taken advantage of a rule to his or her advantage. Overall, we strongly recommend that the government take a step back, withdraw the current proposals, and conduct the comprehensive review and reform of the Canadian tax system that we all agree is needed. BDO stands by our promise to work with the government, with the business and tax communities, and with other relevant stakeholders with the goal of

reforming Canadian tax law to better support the Canadian economy. Our goal is to help achieve tax simplification and tax fairness for all Canadians.

Following are our views and suggestions dealing with the three key issues addressed in the consultation paper. We will first give our views on what we think is good tax policy in each of these three areas, and then make specific comments on the government proposals. We have also included specific comments on intergenerational transfers and the impact of the proposals on the agricultural business community. BDO is a significant provider of tax services to the agriculture sector and we count hundreds of farmers as clients.

Income Sprinkling

Tax on Split Income

The Carter Commission's report in 1966 recognized the difficulty and inequity of taxing an individual, without regard to the close financial and economic ties with his or her family. It recommended taxing the family unit (consisting of a couple, children under 21 and dependent children over 21) on a joint return with the total family income being subject to a family unit rate schedule. The report also recommended that family members who wished to be taxed separately as an individual could elect to do so.

This was the last thorough review of the overall Canadian tax system. And while the Carter Commission's recommendations were not followed by the government when it introduced tax reform in 1972 (the tax unit was maintained as the individual), we believe that this issue should be revisited as part of a comprehensive review of the Canadian tax system before any tax policy is changed with respect to income sprinkling.

We believe that this is even more important when considered in the context of a family business. Family businesses inevitably involve all members of the family, not just the primary entrepreneur, where all contribute in different ways to the business. Family businesses take risks and contribute to the growth of the Canadian economy in ways that salaried employees do not, including job creation, and we believe the tax system should be designed to support these businesses in a manner that is fair to all Canadians. Family business owners do not have safety nets to support them should their business not perform up to expectations or even fail and they often put family assets at risk, such as using the family home as collateral to guarantee business loans. We believe the tax system should recognize this and that Canadian tax policy support this reality.

The last time that income sprinkling was addressed by the Canadian government as a tax policy issue was in 1999, when the Tax on Split Income (TOSI) was introduced. The government made a clear policy choice at that time – that income sprinkling with minors was unacceptable and hence what became known as the "kiddie tax" was introduced. That policy change specifically excluded income splitting with adult family members. It is not a surprise that Canadian businesses arranged their affairs to manage the family tax burden within the boundaries of this tax policy decision of the government.

Now the government is proposing to completely change this tax policy. With respect to these proposals, BDO has the following overall recommendations:

- Any changes to this tax policy should only be made after a comprehensive review of the Canadian tax system, in consultation with all relevant stakeholders, and which includes a review of what the taxing unit should be. BDO strongly believes that, at a minimum, strong consideration be given to considering a couple as the appropriate taxing unit, as the current Income Tax Act does in a number of situations (e.g. pension income splitting, income-tested benefits).
- Any change in tax policy that is considered necessary needs to consider the impact on Canadian businesses of all sizes, and ensure that the changes are fair to businesses and business owners at all income levels. The current proposals seem to be lacking with respect to this impact review.
- The government should make it clear what in particular is causing them concern with the existing policy. There may be easier ways to deal with specific concerns than the current far-reaching proposals. For example, if the government is concerned with income sprinkling with adult family members who are still in school full-time and therefore have lower income, the government could consider extending the current "kiddie tax" to cover family members who are still in full-time attendance at a post-secondary institution.
- Simplification of the tax rules should be a key component of any changes to tax policy in this area. BDO believes that the current proposals fail on this count. We are struggling to interpret how the proposals will impact a number of situations as the new draft legislation is extremely complex and ambiguous. We also believe that the "reasonability tests" being proposed will lead to a great deal of uncertainty and disputes with the Canada Revenue Agency. That in turn will increase tax compliance costs for Canadian businesses. There are a number of measures that could be considered to reduce the subjectivity and increase the certainty of how any necessary changes to the tax policy in this area be handled, such as safe harbours for taxpayers who meet certain conditions (e.g. small business).

Any necessary changes to the tax policy in this area should provide for a reasonable transition period to the new rules to give Canadian business owners time to make consequential changes to how their business is structured. Appropriate transition periods are a key part of ensuring that any necessary tax policy changes are made in a fair manner. In particular, the income sprinkling proposals (including the TOSI and LCGE changes) are to be effective January 1, 2018 with some transition in 2018. However, due to the timing of the consultation and the process that follows until the enactment of changes, there is great uncertainty as to the actions that taxpayers and their advisors should take before 2018 in order to be best prepared to deal with any rule changes that become effective on January 1, 2018. For example, where business structures need to change, the amount of time will most likely be inadequate given that taxpayers will not want to act until they have more certainty with respect to the rules that will be enacted and how they will apply. We believe that, at a minimum, any changes to these rules should be delayed a year, to be effective January 1, 2019.

Specific Comments on the Draft Legislative Proposals for TOSI

The wording of the draft legislative proposals in respect of TOSI are complex and broad, and in many cases they are proving to be very difficult to interpret. In addition, we believe that the explanatory notes that were released with the draft legislative proposals provide very limited

guidance for such complex rules, and tend to provide only a high level view of the rules, but not the necessary detail to assist in applying the rules.

The following are some of the issues and concerns that have been noted with our recommendations to reduce the uncertainty for Canadian taxpayers. Clarity for Canadians will be crucial in order to properly and fairly apply the rules.

- In respect of the reasonableness test under subparagraph 120.4(1)(b)(iii) of the definition of "split portion", the parameters for determining reasonableness for specified individuals who are aged 25 or over will be very difficult to apply due to their broadness and vagueness. In particular, determining whether an amount paid is commensurate with what would have been paid on an arm's length basis taking into account labour, risk and assets contributed is very subjective, which we believe will lead to significant uncertainty for many taxpayers (and their advisors) when trying to ensure amounts paid are reasonable. As well, there are concerns about how this will apply from one year to the next when an individual's contributions change. For example, where a parent actively ran a corporate business for many years, and has now retired, while their child now runs that corporate business and the parent continues to hold shares and receive dividends to fund their retirement (which is common planning), how are the reasonableness tests to apply to those dividends received by the parent in retirement? The legislative proposals in respect of the reasonableness test could be revised to provide more objective measures. However, if steps will not be taken to provide more specific rules in the legislation that include objective measures in respect of the reasonableness tests, then detailed guidance in the form of technical notes with numerous examples will be critical to ensuring that the tests are applied fairly and consistently for all taxpayers. We believe that the government together with a group of key stakeholders should consult further on the parameters of an appropriate reasonableness test with the goal of providing taxpayers with legislation or written guidance that will assist in applying the tests in the most time and cost efficient manner as possible. It will also be very important for this guidance to be available when the legislation comes into effect. BDO would be pleased to work with the Department of Finance, the Canada Revenue Agency and others in the tax community to develop this guidance.
- There is uncertainty in determining the amount of a split portion of a particular amount due to the proposed wording of the definition of "split portion" under subsection 120.4(1). It would seem that the idea of a split portion and the reasonable vs. unreasonable language suggests that one should be able to split out the reasonable portion and not be subject to TOSI on that portion. There is some wording in the proposed definition of split portion, the explanatory notes and on page 25 of the consultation paper that suggests the amount will be considered unreasonable "to the extent" it exceeds what an arm's length party would have agreed to pay to the adult specified individual. Does this mean you carve out the unreasonable portion, and only that portion is included in split income? Or if a particular amount exceeds what is determined to be reasonable, is the entire particular amount included in split income? The wording of the proposed definition of "split portion" makes it difficult to determine with certainty. If the entire amount is to be included in split income to be taxed at the top rate, this is an unfair outcome as this would subject the reasonable portion of the amount to TOSI. However, if only the amount that exceeds the reasonable portion is meant to be subject to TOSI, then the wording in the definition should be clarified

and/or examples should be provided in the explanatory notes to provide guidance in this respect.

- The reasonableness test under paragraph 120.4(1)(c) of the definition of "split portion" that applies to gains on the disposition of property caught under paragraph 120.4(1)(e) of the definition of "split income" is difficult to interpret. It would appear that it is necessary to consider a hypothetical amount of income in place of the gain, which would make it necessary to then consider the relevant reasonableness tests in respect of the hypothetical amount of income. It would be useful for examples to be included in the explanatory notes to provide guidance on how this provision is to apply.
- There is uncertainty of the interplay of the proposed rules concerning inherited property for individuals aged 18 to 24. On the one hand, certain inherited property will be considered to be an excluded amount (under proposed paragraph (a) of the definition of "excluded amount" in subsection 120.4(1)). On the other hand, there is a deeming rule for inherited property that applies for individuals aged 18 and over under proposed clause 120.4(1.1)(e)(ii)(C). This provision includes a reasonableness test, which will ultimately determine whether an amount is a split portion or not, and is then relevant for applying proposed paragraph (b) of the definition of "excluded amount". Therefore, it would appear that both paragraphs (a) and (b) are relevant for individuals aged 18 to 24, however, it is not clear how they are to apply. Does one override the other for this age group, or do they both need to apply? The wording of the definition should be reviewed to ensure this is clear.
- The current definition of "excluded amount" under subsection 120.4(1) is to provide for the exclusion from split income certain amounts that are inherited by specified individuals who are minors where certain conditions are met. Under the proposals, this exclusion has been extended to specified individuals aged 18 to 24 (taking into consideration the issue described in the point above). It is not clear why this exclusion could not be extended to individuals who are aged 25 and older, but instead a reasonableness test comes into play based on proposed clause 120.4(1.1)(e)(ii)(C). For example, we do not believe it is fair that a 27 year old receiving an inheritance should be treated any differently than an individual who is 24 years of age. This issue should be reviewed for fairness.
- The amended wording of subparagraph (b)(ii) and clause (c)(ii)(C) in the definition of "split income" requires a determination of whether income is derived, directly or indirectly, from one or more related sources. This wording has created some uncertainty in terms of what income will be included in split income for purposes of these provisions, as the wording is not specific with respect of the type of income. To reduce the uncertainty of this wording, we recommend a clarification be made to the legislative proposal. For example, if capital gains are to be excluded from this income, since proposed new paragraph (e) is capturing gains, then wording to exclude capital gains should be added to the provision for clarity. We also recommend providing further guidance in technical notes and through examples as to the types of income this provision is intended catch (and not catch), and in what situations income may be considered to be earned indirectly.
- The wording of the anti-avoidance rule under S.120.4(1.1)(d) could be interpreted quite broadly, and therefore it is not clear as to what situations it is attempting to catch. Due to the broad wording of this rule, it appears that it could go beyond the scope of the stated intention of the proposals concerning income sprinkling. Clarification is needed on the following:

- What situations are the target of this provision?
- How broadly to interpret "can reasonably be considered that one of the reasons"… is to avoid TOSI? The concern is that one could argue that investing in one of the property types normally excluded under the TOSI rules, but caught by this provision (for example public company shares), will always be captured as one of the reasons, since income on these investments are not caught up in split income. If this rule remains in place, it is suggested that the wording be narrowed to "the primary reason".
- The rule applies where "any person or partnership acquires or holds a property". Who does "person" include for purposes of this rule? How broadly is the rule to apply? Guidance is needed.
- One of the conditions of this anti-avoidance rule (under paragraph (iv)) references paragraph (b) of the definition of "excluded amount", which is relevant for individuals aged 18 and over. In order to provide more certainty in its application, clarification is needed as to whether this anti-avoidance rule is to apply to all specified individuals or only those who are aged 18 and over.
- Additional guidance (including examples) needs to be provided in the explanatory notes that accompanies the legislative proposals.

Constraining Multiplication of claims to the Lifetime Capital Gains Exemption (LCGE)

The proposals have targeted tax planning arrangements that allow for individuals to claim their LCGE on qualifying property, where they arguably have not invested in, or contributed to, the business value reflected in the capital gains they realize on the disposition of property that is eligible for the exemption. We understand the government's objective in limiting access to the LCGE. However, we have the following concerns and recommendations with the proposals:

- A reasonableness test is being proposed in determining whether the LCGE applies in respect of a capital gain. We have the same comments on the proposed reasonableness test as we outlined under the part of our submission that deals with the TOSI.
- The proposals will no longer permit individuals to claim the LCGE in respect of capital gains that accrue during a period in which a trust holds the property. We do not agree with this proposal. Trusts provide important non-tax benefits to family businesses with respect to succession planning. We feel that the LCGE should be available when qualifying property is held by a trust, if the gain would qualify for the LCGE in the hands of the beneficiary to which the gain is allocated for tax purposes (i.e. this beneficiary would meet the reasonableness test in determining whether the LCGE applies in respect of the capital gain on the property that is being disposed of).
- We have suggested changes to the TOSI proposals – more specifically to reconsider which family members to which the TOSI should apply (for example, we have suggested that the proposed TOSI rules should not apply to a spouse). Any changes to which individuals the TOSI applies, should also be made to the proposals related to the LCGE – for example, if it is determined that the expanded TOSI rules should not apply to a spouse, then the proposed restrictions to the LCGE should also not apply to a spouse.

Owning Passive Investments In a Private Corporation

Canadian tax policy on how passive investment income is taxed in privately held Canadian companies has been clear since the last comprehensive tax reform introduced in 1972. The rules ensure that there is no tax advantage to holding passive investments in a corporation, by taxing such income at a rate that approximates the highest personal tax rate and then ensuring that all or part of the tax on passive income earned at the corporate level is refundable to the company when taxable dividends are paid to the shareholders of the company. The capital dividend account ensures that the non-taxable portion of capital gains earned inside of a corporation can be distributed to the shareholders by way of a tax-free dividend.

Canadian tax policy in this area is based on the principle of integration. This principle ensures for all types of income such as business income or investment income that approximately the same amount of tax is paid overall whether that income is earned by an individual directly or is taxed inside a corporation and the after-tax corporate income is then paid out as a taxable dividend to its shareholders.

We acknowledge that earning business income in a company provides for a tax deferral opportunity when the owners of the corporation do not need access to the after-tax corporate profits until a year in the future. This deferral opportunity exists because of the difference between the general corporate tax rate on business income and the top personal marginal tax rate. A larger difference between tax rates exists if the business income is eligible for the small business deduction.

The government has taken the position in this consultation paper that this tax deferral is unfair. BDO respectfully disagrees with this position for the following reasons:

- The tax deferral is only available if Canadian businesses keep the after-tax profits in their corporations, ready to be available to be deployed in the business. There is absolutely no deferral available if the owners need the funds for personal consumption. In fact, under current tax rates at both the corporate and individual level, in almost all provinces, business profits taxed at the corporate level are "under-integrated". This means that business owners who pay tax on their business profits in their companies and then distribute the after-tax profits out as a taxable dividend will pay more overall tax than if they had been taxed on those business profits directly as an individual.
- The tax deferral available to Canadian corporations has been driven by a clear tax policy to lower corporate tax rates to ensure that Canada remains a competitive place to do business. Part of the reason for these lower corporate tax rates on business income is to provide businesses the opportunity to save – to maintain their businesses and employment levels during economic downturns where business profits drop (and access to savings are important) or to save for significant investments in their business (which may only happen every few years). Taxing passive income at higher tax rates to "clawback" the benefits of a tax deferral will mean that Canadian businesses will have less resources available for these types of objectives. We understand that in the recent economic downturn in Alberta, private Canadian businesses did a better job at maintaining their employment levels than did larger public companies – using savings at the corporate level to help them through these difficult times.

- Many Canadian businesses have financing arrangements that require them to leave a certain level of retained earnings (after-tax business profits) inside their corporation and limit what can be distributed to the shareholders as a taxable dividend. This could unfairly impact these businesses if the rules on how passive income is taxed in a corporation are changed as proposed.
- Many successful businesses, particularly true in the technology sector, will use the after-tax corporate profits from their business to invest in start-up businesses. This represents an important source of capital for start-ups that will be negatively impacted if the tax rules on passive income are changed to "clawback" the corporate tax deferral.
- These changes may negatively impact women entrepreneurs who want to take time off or reduce their working hours for maternity reasons. Corporate savings can give them resources to draw on during these periods. It should be pointed out that unlike salaried employees, business owners do not have access to any benefits or have limited employment insurance support during parental leaves.

We recognize that the government has not yet put forward draft legislation for this issue. We believe that this is due to the fact that the government itself is struggling with what should be the right tax policy in this area. That is why this and other issues should be discussed under a comprehensive review of the entire Canadian tax system, with a full consultation with all stakeholders, before any changes are proposed.

We would also like to make two additional comments as we believe the ideas that the Department of Finance has put forward violate two fundamental principles of good tax policy:

- *Integration* – This is an important pillar of Canadian tax policy, a pillar that is to be respected to ensure certainty and fairness in the Canadian tax system. The ideas that have been put forward by the Department of Finance will destroy the concept of integration as it relates to passive income taxed at the corporate level, where the source of funds for those investments were after-tax business profits. For an Ontario resident individual who pays tax at the top personal tax rate, the effective tax rate on passive income earned in a corporation will increase substantially. The effective tax rate could increase from 56% to 73% for interest income for certain taxpayers, which we do not believe is fair.
- *Tax Simplification* – The ideas put forward by the Department of Finance are extremely complex. It will substantially increase tax compliance costs for private Canadian companies. This is contrary to the objective of a comprehensive tax reform – that the tax rules be simplified wherever possible.

BDO has the following recommendations:

- No further action be taken until there is a comprehensive review of the Canadian tax system where this issue can be discussed.
- BDO is of the view that the tax deferral, which is provided through the laws of the Canadian tax system, is good tax policy for the reasons articulated above. If the government has specific abuses that they are concerned with, we would be happy to discuss this to find targeted solutions that deal with the specific abuse and do not impact the Canadian business community at large.

Converting Income into Capital Gains

The government has proposed changes to the Income Tax Act designed to prevent shareholders of private Canadian corporations from being able to extract surplus from their corporations as a capital gain, rather than as a dividend, in non-arm's length situations. We understand that the government is concerned with certain tax planning being undertaken to take advantage of the lower tax rates that currently apply to capital gains when compared to dividends and we agree that it is appropriate that the government take steps to eliminate the tax advantage that certain types of tax planning can create.

Our concerns with the detailed government proposals are as follows:

- The proposed changes to section 84.1 and the new section 246.1 are too broad and will increase the tax cost to Canadian business owners and their families in situations which we think the government did not intend. There are ways to amend the Income Tax Act in order to stop the planning that the government is concerned with and to not potentially affect other transactions which we believe are within government tax policy.
- Some of the proposals are retroactive and will apply to transactions where capital gains were triggered prior to July 18, 2017. We believe that this is unfair and that any changes should only apply to capital gains that are triggered on or after July 18, 2017.

The following describes our concerns in more detail:

Impact of Changes to Section 84.1 on Post-Mortem Planning

The changes to section 84.1 significantly impact tax planning that is currently undertaken involving most Canadian private corporations to prevent double taxation on the death of a shareholder. On death, an individual is subject to a deemed disposition of all their assets at their fair market value, including shares of a private Canadian company resulting in tax on the resulting capital gain. Tax will also be payable within the corporation on any accrued gains at that level. Post-mortem or pipeline planning is designed to ensure that the deceased and their estate are only subject to tax once, as a capital gain. The changes to section 84.1 will substantially increase the effective tax rate on this planning – to a dividend tax rate if the estate can be wound up within one year and a capital loss can be created to eliminate the capital gain reported by the deceased individual, or to an even higher tax cost if tax planning cannot be completed within one year of death. These proposals will apply, even if a post-mortem plan in progress has a tax ruling from the Canada Revenue Agency. We include a simple example, attached as Appendix 2, which demonstrates how this works.

BDO Recommendations

- BDO believes that the government did not intend to increase the effective tax rate on death for a deceased and their estate where shares of a private Canadian company were part of the estate. We recommend that if the changes to section 84.1 are implemented, they should exempt from section 84.1 the adjusted cost base of shares that is created on the death of an individual.
- BDO requests that the time for the subsection 164(6) carryback (to allow a carryback of a capital loss to offset a capital gain reported on death) be increased to three years after the

date of death from one year. A three year time frame is consistent with the recent introduction of a "graduated rate estate", which can exist for three years from the date of death in recognition of the fact that it can often take more than one year to deal with tax and legal consequences in the estate. We believe that giving a taxpayer's estate more time to deal with the tax consequences of an estate's affairs is reasonable and fair.

- If post mortem planning is to be impacted by these changes, the proposed rules need to be changed to ensure that they do not apply to deaths that occurred before July 18, 2017.

Retroactive Application of Changes to Section 84.1

Although the draft legislation states that the changes to section 84.1 are applicable to dispositions on or after the Announcement Date, the "previous dispositions" referred to in revised subparagraph 84.1(2)(a.1)(ii) includes dispositions prior to the Announcement Date, all the way back to 1984. This means that any transactions done before July 18, 2017 that resulted in capital gains tax being paid in any non-arm's length situation, will not be effective in creating adjusted cost base that could be extracted from a company. In fact, double tax could result if funds are withdrawn because under the proposed changes a deemed dividend will result. The cost base created on a non-arm's length transaction will only be able to be used on an arm's length sale of the shares going forward.

While we understand why the government made this change for any dispositions that result in capital gains on or after the Announcement Date, it is unfair to effectively amend section 84.1 and the tax consequences that arose from a non-arm's length sale, on transactions that occurred before the Announcement Date. Any changes in the tax law that retroactively change the tax consequences of prior transactions is just not fair. Canadians have the right to be able to plan their tax affairs under the tax law as enacted or announced on the date that their transactions take place.

BDO Recommendation

- Amend the changes to section 84.1 to ensure that the changes cannot apply to any capital gains triggered on transactions that took place prior to the Announcement Date.

General Impact of New Section 246.1

New section 246.1 is an anti-avoidance provision intended to prevent the distribution of corporate surplus which would otherwise be distributed as a taxable dividend to an individual shareholder resident in Canada, on a tax-reduced or tax-free basis in a non-arm's length transaction. We have struggled to understand what the new rule is targeted at as it could apply to any non-arm's length transaction where a capital gain is triggered whether motivated primarily by tax or other non-tax reasons.

We are also concerned with the effective date of the rule. We believe that any new rule such as this should only apply to transactions that took place on or after the Announcement Date. However, as the proposed rule applies "in respect of amounts that are received or become receivable on or after the Announcement Date", we believe that this rule as currently drafted will unfairly apply to situations where a capital dividend was declared and paid after the announcement date (where the capital gain that resulted in the addition to the capital dividend account (CDA) took place prior to the Announcement Date), or possibly to situations where notes

were received on transactions that occurred prior to the Announcement Date but have not yet been paid by the corporation.

BDO Recommendations

We have the following recommendations with respect to proposed section 246.1:

- The government provide examples of situations to which they intend to apply section 246.1 and where they do not intend to apply it. This should be done in consultation with the professional tax community. BDO would be pleased to work with the Department of Finance and others in the tax community to develop this guidance. This might be similar to the guidance the government issued on the initial introduction of the General Anti-Avoidance Rule (GAAR).
- The wording of proposed paragraph 246.1(2)(d) be amended to state that "the primary purpose of the transaction …" from its current wording "one of the purposes of the transaction …". This would limit the application of this anti-avoidance rule to situations where tax was the motivating purpose of the transaction or series, which would be consistent with the wording of the purpose test for GAAR.
- The effective date be changed to transactions which resulted in the capital gain occurred on or after the Announcement Date. BDO believes that changes to the tax consequences of transactions retroactively are not fair and have no place in the Canadian tax landscape.

Inter-generational Transfers

For family businesses, the backbone of our economy, the ability to transfer a going concern business to the next generation in a tax efficient manner is an important consideration. We respectfully do not understand the policy behind making such a transfer more costly from a tax perspective than a sale to an arm's length buyer.

Example

The following example[1] illustrates how the proposed rules create such an increased cost. This illustration uses a farm corporation - however the additional tax cost it illustrates could also be applicable to incorporated businesses that are qualified small business corporations.

Current Rules

Jack owns all the shares of a family farm corporation which are valued at $6 million and have nominal cost base. Part of his succession plan includes the sale of the shares to his son Matthew for $4 million using the intergenerational transfer rules currently available in the Income Tax Act. Jack will be paid off over the following 10 years.

The plan is for Matthew to use corporate funds to pay for the full purchase price over time as he does not have the personal resources or income to do so. Jack has been informed that if he uses his capital gains exemption Matthew would incur additional tax costs to access that value from

[1] Note that this example is the same as one used in our letter of September 25, 2017 to the Minister of Agriculture and Agri-Food.

the corporation, so Jack has agreed not to use his capital gains exemption which results in an additional tax cost to Jack under the current tax rules.

Matthew will buy the shares from Jack and immediately transfer them to a new holding corporation in return for a promissory note. Matthew will use the promissory note to access corporate after-tax income to pay for the shares.

Under the current rules Jack will have a taxable capital gain on which he will pay tax.

Matthew will be able to access after-tax corporate funds via the promissory note to pay Jack for the purchase.

Proposed Rules

Under the proposed rules Jack will still have a capital gain on which he will pay tax. However Matthew will now be considered to have a dividend of $4 million and will be subject to tax on that amount.

Under the proposed rules the same value is being taxed twice – first as a capital gain to Jack on the sale of the shares to Matthew and then again when Matthew transfers the shares to his holding company to provide funds to pay for the shares.

Alternatively, pursuant to the proposals, if Jack sold the shares to an arm's length corporate purchaser (unrelated purchaser) he would be able to use his capital gains exemption and the purchaser would not have to pay tax again on that value as a dividend like Matthew would have to. The arm's length purchaser could access the corporate after-tax income to pay Jack and not incur any additional income tax.

As demonstrated, under the new proposals, it is more expensive to transfer property from one generation to another, than to sell to an arm's length buyer. Many family businesses stay in the family for more than one generation. These proposals will make this more expensive, and it is not fair to penalize family businesses in this way. Surely it was not the intent of these proposals to make selling a Canadian family business to a public company or a non-resident company less costly than to a family member. The succession of family businesses in Canada is one of the most important issues facing family business owners today and this punitive treatment will result in significant consequences to the Canadian family business environment.

Recommendation

It is recommended that more time be allowed to arrive at a reasonable compromise position, one that recognizes both the concerns of the Department of Finance with respect to surplus stripping and the concerns of family businesses where the intent is to pass an active business to the next generation. We would be happy to work with you on such an extended consultation.

<u>Interaction between the TOSI rules and the stripping rules on an inter-generational transfer</u>

In addition to the general concerns expressed above, we also wish to draw your attention to a technical issue that is particularly punitive. The proposals contain impediments to the inter-generational transfer of incorporated businesses in both the TOSI rules and in the new section 84.1 rules. In fact, these rules could over-lap such that both new section 120.4(4) and section 84.1 apply to the same shares, in a series of transactions that transfer the shares to the next generation in an inter-vivos transfer.

Consider the transfer of shares from a non-active shareholder parent to an adult child. Under proposed section 120.4(4), a deemed ineligible dividend equal to twice the taxable capital gain that arose on the sale of the shares will be created. The inactive parent would not be able to claim the capital gains exemption on such a transfer of shares. The child, if they transfer the shares acquired to a holding company in order to access corporate funds to pay for the shares, will be subject to a deemed dividend under section 84.1. The result is the same deemed dividend amount being taxed twice.

Pursuant to the current rules, the parent would not be able to claim the capital gains exemption on the sale of shares to the adult child if they wish to avoid the child being subject to section 84.1 when funds are accessed from the child's holding company, but they would have a capital gain and not a dividend.

With respect to this specific technical matter, BDO has the following recommendation:

- Based on the proposed changes to section 84.1 and the LCGE rules, it should not be necessary to have subsection 120.4(4), and we suggest that this subsection be repealed. However, if subsection 120.4(4) is not repealed, then we suggest that an exception be made in subparagraph 84.1(2)(a.1)(ii) to create "hard cost base" to avoid having the gain that was taxed as a dividend due to subsection 120.4(4) taxed again as a dividend under section 84.1.

Impact of the Proposals on Agricultural Businesses

We would like to comment on the proposals with respect to farming businesses. All of the proposals potentially apply to all farmers, regardless of the size of their farming operations. In particular, we are very concerned with the application of the proposals to the intergenerational transfers of farming businesses. The comments we have made with respect to intergenerational transfers apply equally to farmers, and the impact will be even greater in some cases due to the availability of the LCGE on farming property, in addition to shares of farm corporations.

We believe that the impact of the proposals to farming businesses are beyond what the government intended and we strongly believe that more consultation is needed with all relevant stakeholders before any changes are implemented. BDO would be pleased to participate in further consultations on the impact of these proposals to ensure that the right tax policy is developed to appropriately support this important sector of the Canadian economy. BDO services hundreds of agriculture businesses and farms and we would be very interested in working with you to better serve this important sector of our economy.

We have enclosed in Appendix 3 a letter we have sent to the Minister of Agriculture, outlining our concerns. It contains a number of examples of how the proposals can negatively impact farming businesses and their families.

BDO is proud of our position as one of the leading professional service firms in Canada and the leading professional services firm when it comes to our Canadian mid-market and private businesses and we are proud to serve thousands of hard working Canadian business owners and families and individuals, who are true entrepreneurs and drivers of the Canadian economy. We have heard from them loud and clear how serious their concerns are with these proposals, and the intention of this submission is to bring those concerns to your attention. We would welcome the opportunity to work with you to improve the Canadian taxation system, and to truly increase fairness and transparency for all Canadian taxpayers.

Thank you for your attention to these important matters.

Dave Walsh

Dave Walsh, CPA, CA

Tax Service Line Leader

BDO Canada LLP

Appendix 1

Illustration of TOSI rules at lower income levels

Assumptions
Corporation X owned by Mr. and Mrs. A
Each own 50% of common shares
Mr. A is active in the business
Mrs. A is not active in the business

Income earned in corporation	$120,000
Corporate Tax (15%)	$ (18,000)
After tax profits	$102,000
Actual dividends paid	$51,000

	Current Rules		Proposed Rules	
	Business Owne	Spouse Owner	Business Owner	Spouse Owner
Taxable Dividend	$59,670	$59,670	$59,670	$59,670
Interest Income	$15,000	$15,000	$15,000	$15,000
Taxable Income	$74,670	$74,670	$74,670	$74,670
Tax if only income was interest income	$522	$522	$522	$522
Incremental tax on dividends	$7,023	$7,023	$7,023	$23,103
Tax at 2017 Ontario rates	$7,545	$7,545	$7,545	$23,625

Ontario top rate on ineligible dividends	45.30%
Ontario small business tax rate	15%
Actual Ineligible Dividend	$ 51,000
Taxable Dividend	$ 59,670

Taxes estimated using Taxprep 2017 Planner

As can be seen in the example above, the tax that would be paid on dividends paid to a lower-income, non-active shareholder under the proposed changes is significantly higher than the tax that would be paid by such a shareholder under the current rules, or to an active shareholder under the proposed rules. There is no family income threshold in the proposed rules, and as such, the proposed changes could apply to a lower-income family as well as to a higher-income family.

Appendix 2

Example of impact of Section 84.1 changes on post-mortem planning			
	Existing pipeline planning	Impact of new 84.1 proposal	Alternative existing 164(6) planning
HoldCo value	$1,000,000	$1,000,000	$1,000,000
Tax on capital gain on death	$ (250,000)	$ (250,000)	$ (420,000)
Net value after estate tax	$750,000	$750,000	$ 580,000
Additional tax to adult children when pipeline is used for asset distribution		$ (420,000)	
Final after-tax funds	$750,000	$330,000	$ 580,000
Effective tax rate	25%	67%	42%

Assumptions

1. Parent dies leaving company worth $1,000,000 to 2 adult children
2. Children sought ruling from CRA to carry out pipeline planning
3. Applicable capital gains tax rate - 25%
4. Applicable dividend tax rate - 42%

Appendix 3

September 25, 2017

The Honourable Lawrence MacAulay, P.C., M.P.

Minister of Agriculture and Agri-Food

Confederation Building

Suite 507

House of Commons

Ottawa, Ontario, K1A 0H8

Dear Mr. MacAulay,

Re: Impact of the July 18, 2017 Private Company Consultation Paper on Farmers and their Farming Businesses

On July 18, 2017, the government introduced a consultation paper entitled Tax Planning Using Private Corporations. This paper proposed 4 major changes to government tax policies, all of which will impact agricultural businesses in Canada from coast to coast. These changes cover the following four areas:

- Income Sprinkling between family members from the farm business, which will increase the annual tax cost for the family from their farm business;
- Availability of the Lifetime Capital Gains Exemption (LCGE) for family members, whether on the transfer of ownership of shares of a family farm corporation or farmland, which will increase the tax cost of intergenerational transfers;
- Taxation of passive income earned in a family farm corporation, which will increase the tax cost of farmers saving for future investment in the farm, for difficult years when profits from the farming business are low, or for retirement; and
- Changes to section 84.1 which will increase the tax cost of intergenerational transfers of shares of a farm corporation.

We have listed a number of examples in the Appendix which demonstrate how the proposals will impact farming businesses and the families behind these businesses. We have the following comments with respect to these examples:

1. The first example demonstrates how many succession plans for farming businesses will be impacted, due to the fact that, under the proposals, taxes will substantially increase for dividends from family farm corporations paid to family members who are no longer active in the farm, as well as the fact that these family members will no longer be able to claim the LCGE with respect to farming property;
2. The second example demonstrates how the annual tax cost for a farming family could increase on the income earned from the farm business – and will also increase the annual tax compliance cost for the farm business as documentation will now have to be kept to prove the reasonableness of any income paid to family members;
3. The third example demonstrates how the income sprinkling and LCGE changes will increase the tax cost of succession plans for farming business;
4. The fourth example also demonstrates how the tax cost of an intergenerational transfer will increase, even when capital gains tax is paid on the transfer;
5. The fifth example demonstrates how, under the proposals, a sales of a family farm business to an arm's length party will be more tax efficient than an intergenerational transfer of the business (due to the combined changes in section 84.1 and the changes to the availability of the LCGE)
6. The sixth example demonstrates how the retirement plans of many farmers will be negatively impacted by the proposals to change how passive income is taxed inside a private corporation.

There are more examples as well. These proposals are far-reaching and will impact all farming businesses across the country. As a result, we believe the government should slow down and fully analysis the impact of these proposals on the agricultural sector before proceeding. BDO stands ready to assist the government in developing appropriate tax policy to with the goals of appropriately supporting the Canadian agricultural sector and being fair to all Canadians.

We would be pleased to discuss the contents of this letter at your convenience.

Sincerely Yours,

Dave Walsh, CPA

Tax Service Line Leader, Canada

BDO Canada LLP

cc: The Honourable Wayne Easter, P.C., M.P.

APPENDIX

Example 1 – Incorporated Farm Business owned by a husband and wife

John and Darlene carry on a farming business through a corporation, and own shares in that corporation.

Their two adult children, Bob and Sue, are also shareholders of the corporation.

Bob and Sue worked for many years on the farm after school, during summer vacations, etc. when they were children, which was vital to the success of the farm. As in many family business they were not compensated for the value of their labour since it was expected that everyone need to contribute to the family farm.

Bob went off to pursue another career and Sue remains active in family farm.

Bob and Sue acquired their shares of the corporation for $1 each following an "estate freeze" by John and Darlene.

Bob is not actively involved in the farming business, while Sue is.

Although Bob is not involved in the farming business, part of John and Darlene's estate plan involves paying dividends to Bob from the company, as John and Darlene have no other significant assets outside the farm company.

Under the Proposals, dividends paid to Bob would likely not be considered "reasonable" and therefore, attract tax at the highest marginal tax rate for the province of residence. This represents a significant tax cost to Bob and effectively reduces his inheritance

Example 2 – Partnership

Paul and Beth are married and carry on a farming business through an informal partnership. They are equal partners and share the income of the partnership on a 50/50 basis. They both contributed equally to the partnership when it was formed.

In 2018, they had a child and they both agreed that Beth would spend more time raising the child than operating the partnership.

Under the Proposals, if 50% of the partnership income in 2018 is allocated to Beth, some or all of that allocation could be viewed as "unreasonable" based on her contributions (labour, capital, risk assumed) for that year were not as significant as Paul's. The "unreasonable" amount would attract tax at the highest marginal tax rate for the province of residence. This represents a significant tax cost to Paul and Beth for what should be a "simple" farm partnership structure. (Query: how does this interact with 103(1.1)?)

Example 3 – Intergenerational rollover transfer and TOSI

Jack and Helen have been carrying on farming in a corporation since the early 70s and they own it equally. This has allowed them to pay lower tax and reinvest in farmland, quota, equipment

etc. They both started the farm together and have made significant contributions, as such is it assumed any dividend they receive would be reasonable under the TOSI proposals.

They have two adult sons over 25 years of age, Barry and Kevin, who are active in the farm operation on a day to day basis. They are paid a reasonable amount for their services from the farm corporation.

They also have an adult daughter, Ruth, who is not active in the business.

The farm has been successful with the majority of the debt paid off. Barry and Kevin have never contributed any capital and have not had to guarantee any loans for the farm operation.

Jack and Helen have decided to transfer 90% of their shares of the farm corporation to their two sons equally at the tax cost. The remaining 10% is frozen into fixed value preference shares and gifted to their daughter Kim as part of her inheritance.

All dividends received by the Barry and Kevin will be considered "unreasonable" and subject to TOSI. They are not deemed to make the contributions that were made by their parents when the shares were transferred to them. Additionally, since any dividends on the shares would be TOSI any gain on the shares will also be considered TOSI and not eligible for the capital gains exemption. If the shares were eligible for the capital gains exemption for Barry and Kevin, then they would need to determine the gain on the shares for years they were under 18 years of age since that will not qualify for the CGE as they received the shares on a rollover basis.

For Ruth, any dividends and gains will be considered TOSI and no access to the gains exemption. The plan was to sell the shares to her brothers and use her gains exemption but now that planning is ineffective.

As an alternative option to allow Ruth to liquidate her shares, life insurance was purchased on Jack and Helen by the corporation. On the death of the survivor of Jack and Helen the life insurance proceeds would be used to redeem Ruth's shares using the capital dividend account. Proposed section 246.1 may convert the otherwise tax-free capital dividend to fully taxable dividend which significantly reduces Ruth's inheritance.

Example 4 - Restriction on the capital gains exemption on farm real estate

John and his son Mark are full-time farmers in a family farm operation.

John wants to transfer a farm he owns to his son Mark. The farmland is worth approximately $1,000,000. John acquired the farm 30 years ago ~ the year Mark was born ~ for $100,000. The farm was worth approximately $500,000 12 years ago ~ the year Mark turned 18.

John has already used his lifetime capital gains exemption and does not want any consideration for the farm, i.e. he wants to gift the farm to Mark and avoid triggering tax.

John is able to transfer the farm to Mark without triggering tax, using the intergenerational rollover rules.

Under the Proposals, if Mark decides to sell the farm down the road, he will not be able to shelter $400,000 of the resulting capital gain using his capital gains exemption because that is the portion of the gain that accrued on the farm before he turned 18. This represents a significant tax cost to Mark, even though he was an adult when he received the farm from his father. Absent the Proposals, this gain could be sheltered by his capital gains exemption.

Alternatively, assume Mark held onto the farm and in the future transferred the farm as a gift to his own adult child. His child would not be able to use his capital gains exemption for any gains accrued before turning 18 years of age. Again, this could represent a significant tax cost.

The above outcome could also apply on the transfer of shares of a family farm corporation or an interest in a family farm partnership using the intergenerational transfer rules currently available.

Example 5 – Restriction on the capital gains exemption on the sale of shares of a Farm Corporation to next generation

Jack owns all the shares of a family farm corporation which are valued at $6 million and have nominal cost base. Part of his succession plan includes the sale of the shares to his son Matthew for $4 million using the intergenerational transfer rules currently available in the Income Tax Act. Jack will be paid off over the following 10 years.

The plan is for Matthew to use corporate funds to pay for the full purchase price over time as he does not have the personal resources or income to do so. Jack has been informed that if he uses his capital gains exemption Matthew would incur additional tax costs to access that value from the corporation, so Jack has agreed not to use his capital gains exemption which results in an additional tax cost to Jack under the current tax rules.

Matthew will buy the shares from Jack and immediately transfer them to a new holding corporation in return for a promissory note. Matthew will use the promissory note to access corporate after-tax income to pay for the shares.

Under the current rules Jack will have a taxable capital gain on which he will pay tax.

Matthew will be able to access after-tax corporate funds via the promissory note to pay Jack for the purchase.

Under the proposed rules Jack will still have a capital gains on which he will pay tax. However Matthew will now be considered to have a dividend of $4 million and will be subject to tax on that amount.

Under the proposed rules the same value is being taxed twice – first as a capital gain to Jack on the sale of the shares to Matthew and then again when Matthew transfers the shares to his holding company to provide funds to pay for the shares.

Alternatively, under the proposals, if Jack sold the shares to an arm's length corporate purchaser (unrelated purchaser) he would be able to use his capital gains exemption and the purchaser would not have to pay tax again on that value as a dividend like Matthew would have to. That is, the arm's length purchaser could access the corporate after-tax income to pay Jack and not incur any additional income tax.

Example 6 – Farm Corporation liquidating assets upon retirement of the farmer

Jim has operated his feedlot business through a corporation for many decades. The corporation is owned equally by Jim and his wife Dianne. The use of the corporation has beneficial to reduce income tax and allow them to invest in livestock & equipment, buy additional farms and also to hire employees. As allowed under the Income Tax Act, the livestock were deducted as a business

expense when purchased and therefore the proceeds from selling off the livestock will be fully taxable to the corporation.

They do not have any successors as all their children have off-farm careers. It has been decided to liquidate the farm operation on an orderly basis over a number of years. The plan is to gradually reduce their herd over a number of years and pay the low-rate corporate tax on the proceeds. Jim and Dianne do not have any other personal investments as they have constantly re-invested in their farm operation, so they will need funds from the corporation for their retirement. The sale proceeds will be held by the corporation and invested. Jim and Dianne will draw funds from the corporation as needed as dividends.

The government's consultation paper proposes that the passive income earned on capital in the corporation, on which low rate corporate tax was originally paid, would significantly increase. The combined (corporate and personal) effective tax rate could be as high as 73%. Currently, based on the top personal tax rate in Ontario, the combined income tax is approximately 54%.

Additionally, the dividends that Jim and Dianne take from the corporation will be subject to a "reasonableness" test. After liquidation the company's principal purpose will be to derive income from property (passive investments) and both Jim and Dianne will be deemed not to have performed any labour functions for the company in determining if the dividend is reasonable, even though they have worked for decades in the farm operation.