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The Honourable Bill Morneau
Minister of Finance
Centre Block, suite 435S
House of Commons
Ottawa, Ontario
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October 2, 2017

VIA EMAIL

Dear Mr. Morneau:

Re: Consultation regarding Tax Planning Using Private Corporations

This letter is in response to the proposals (the "Proposals") released by the Department of Finance on July 18, 2017 via its consultation document: Tax Planning Using Private Corporations (the Consultation Document"). In summary, the Proposals will discourage entrepreneurship, prevent the succession of family businesses and decrease economic activity in Canada. The government should abandon these Proposals, and undertake true tax reform with true consultation with all impacted parties, like the Royal Commission on Taxation that was completed in 1966.

GENERAL COMMENTS

Adding to the complexity and uncertainty of the tax system

The government has stated it wants to simplify the tax system. Many tax experts have stated these Proposals are the most complex that have ever been proposed.[1] Further, an attendee at the recent discussion between the Canadian Tax Foundation ("CTF") and the Department of Finance, noted that the CTF had to explain to the Department of Finance, that under the Proposals, a person selling a corporation carrying on a business to a family member would pay more taxes than if that person sold their corporation to a third party.[2]

The word "reasonable" shows up in the draft legislation seven times making application of these rules uncertain as there is no definition of "reasonable" under the Income Tax Act. The courts have struggled with "reasonable" in the context of salary and management fees. This struggle

1 For example, see Moody Gartner Tax Law PowerPoint presentation presented September 1, 2017, "What do the new July 18, 2017 Canadian Private Corporation Tax Proposals Mean for You?"
[2] Cathie Brayley's post on LinkedIn, September 27, 2017. Ms. Brayley is a Partner at Clark Wilson LLP.

will only increase when it comes to investment returns, dividends and capital gain allocations for family members from the income splitting proposals.

Time-period and scope of consultation

The consultation process has been extremely rushed especially when compared to other consultations that the Department of Finance has done in the last two years that have less impact on Canada's economy.[3] Therefore, not only more time should be given to study these issues, but the entire tax system should be reviewed as these Proposals are among the most significant in the last 50 years. You keep saying you "want to get it right", but that is simply not possible when this process was rushed with only a 75-day consultation period. Even all three of Canada's largest newspapers (The Globe and Mail, the National Post and the Toronto Star) which cover the entire political spectrum have stated a need for greater tax reform that goes well beyond these Proposals.

Undefined terms

The Proposals use the words "fair", "middle class", and "loopholes" but does not define them. How can there be any sort of consultation when these terms are undefined?

For example, here is a partial list of activities which some could consider to be "unfair" but the Proposals do not address these items:

- Executives at Canada's largest corporations can have 50% of any income inclusion be tax-free relating to stock options if the price paid for the share is not less than the FMV of the share when the option was granted[4].
    - More tax revenue would be generated and would be easier to generate by fully taxing stock options rather than implementing these Proposals according to the Liberal Party and the Department of Finance's own numbers.[5]
- Families with one high income earner and a low-income earner can shift investment income between the spouses by using "prescribed rate loans". If there are children, a family trust can be used to split income with their children. Given the size of the portfolio needed to make this economically worthwhile, only "wealthy" individuals can benefit from this planning.
- Pensioners can split their income with their spouse.
    - The government has not made it clear as to why pension income splitting and investment income splitting is "fair" and business income splitting is "unfair."
- One household that has one person making $100,000 and the other spouse earning zero pays more tax than another household were two spouses make $50,000 each.

[3] For example, the Department of Finance provided 105 days to review regulated pension plans, 130 days to review the financial sector framework and 130 days to review mortgage-backed securities.
[4] 110(1)(d) of the Income Tax Act.
[5] The Liberal Party estimated that in 2014 the cost of the stock option deduction was $750 million in the 2015 Liberal Party Platform on page 80. The Department of Finance estimates these Proposals will generate $250 million (page 15 of the Proposals).

- MPs can receive tax-free allowances for personal and living expenses[6] but other workers receiving similar benefits are partially[7] or fully[8] taxable.
- Teachers can claim a tax credit for supplies[9] used in their job while other employees cannot

Many Canadians are likely considered to be “upper middle class” or even “wealthy” with their family income between $100,000 and $200,000 by your government, which is approximately the amount earned by MPs and other top government officials. However, from a practical point view, after taxes and other living expenses such mortgage payments, car payments and extra-circular activities for their children, they are not wealthy. They do not have significant assets and/or have significant debt. Classifying them in the same group as millionaires is not a true comparison.

Also, the Department of Finance has been misleading the Canadian public to call decisions from the Supreme Court of Canada as “loopholes”[10] as well as the current system of taxation that has been in place for the last 50 years.

Specific attack on Professionals

It is not clear why professionals such doctors, lawyers, accountants and other professionals are being specifically being targeted as well as the “wealthy”. Professionals are business people and are no different than any other business person, including farmers, and the tax system should treat them the same. I am quite confident that there are many professionals that generate less gross income than many public servants yet do not receive the benefits these public servants receive, such as a guaranteed pension on retirement.

Lack of a size test in the draft legislation and the commentary on the passive income Proposals

While the government keeps repeating the message that these rules are meant to apply to the wealthiest of Canadians, there is no mention anywhere of a size test in the Consultation Document or the draft legislation. As I am sure you know, there are size tests for the small business deduction and the refundable rate for Scientific Research and Experiment Development expenses generated by a CCPC. To ensure that these rules only apply to the wealthiest of Canadians, a size test needs to be introduced with a large capital base, say $25,000,000, before any of these rules apply.

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[6] 6(1)(b)(i) of the Income Tax Act
[7] See for example, the clergy residence deduction under 8(1)(c) of the Income Tax Act, and the reduction of taxable benefits from working at a remote worksite under 6(6) of the Income Tax Act.
[8] 6(1)(b) of the Income Tax Act
[9] Section 122.9 of the Income Tax Act
[10] See Neuman vs. the Queen that allowed any amount of dividends to be paid to shareholders regardless of contributions.

Claims that these Proposals were in the Liberal Party Platform

On numerous occasions, you have stated that these Proposals were clearly indicated in the Liberal Party Platform from the 2015 election.[11]

In reviewing the Liberal Party Platform, only income splitting is mentioned and further, the platform does not mention what type of income splitting would be cancelled. As mentioned above, there is pension income splitting, investment income splitting and business income splitting. There are no references to CCPC's earning "passive" income or the income to capital gain conversion transactions.

Also, the following items were laid out in the Liberal Party Platform on page 80 but have not been carried out – my emphasis in **bold.**

- We will conduct a review of **all** tax expenditures to target tax loopholes that particularly benefit Canada's top one percent.

- **A starting point would be to set a cap on how much can be claimed through the stock option deduction**. The Department of Finance estimates that 8,000 very high-income Canadians deduct an average of $400,000 from their taxable incomes via stock options. This represents three quarters of the fiscal impact of this deduction, which in total cost $750 million in 2014. Stock options are a useful compensation tool for start-up companies, and we would ensure that employees with up to $100,000 in annual stock option gains will be unaffected by any new cap.

- As **we reduce the small business tax rate to 9 percent from 11 percent**, we will ensure that Canadian Controlled Private Corporation (CCPC) status is not used to reduce personal income tax obligations for high-income earners rather than supporting small businesses.

In other words, the "starting point" was dismissed almost immediately under the stated reason that the removal of the stock option deduction would impact small start-ups negatively, even though a solution was offered in the Platform. Further, the small business tax was not cut to 9% but the "review" of CCPC taxation still went ahead.

Improper use of statistics to justify the "fairness" of these Proposals to average Canadians

The Department of Finance has stated the number of corporations growing from the year 2000 is because of the number of people who want to access the "tax advantages afforded by tax planning in relation to private corporations".

[11] For example, I refer to your conversation with Joy Thomas, President of CPA Canada at the CPA The One Conference on September 18, 2017 where the message you communicated was: "These policies were clearly laid out on page 80 of the Liberal Party Platform".

While that may be a factor in incorporating, I would say a more logical explanation would the growth of the economy in general as well as large businesses, the federal and provincial governments requiring contractors to incorporate.

CRA does not seem to have an issue with anyone incorporating their business (including professionals)[12]– see IC 88-2 "General Anti-Avoidance Rule – Section 245 of the ITA",

11. Incorporation of a Proprietorship

Facts

An individual taxpayer transfers his or her business to a corporation primarily to obtain the benefit of the small business deduction.

Interpretation

There is nothing in section 125 (that provides for the small business deduction) or elsewhere in the Act that prohibits an individual from incorporating his or her business. The incorporation is consistent with the Act read as a whole and, therefore, subsection 245(2) would not apply to the transfer of the business to the corporation.

You have also said "No wonder some estimate that two thirds of the wealthiest 0.01 per cent own a CCPC".[13] I would argue that wealthy Canadians, who have built their wealth with business activities, would mostly likely use a corporation to carry on their business activities. And if the person is Canadian, then it would automatically make the company a CCPC. Put another way, how many of the wealthy Canadians who are in the .01 percent operate their business as a sole proprietorship? I suspect the answer is very few if not zero. Therefore, this statistic you have cited is irrelevant.

SPECIFIC COMMENTARY - INCOME SPRINKING

The expansion of the "tax on split income" has created situations that will make it difficult for start-up companies to attract capital from their family and can generate non-sensical results.

For example, a person who lends money and takes an equity stake in a start-up owned by a relative will likely be taxed at the top marginal tax rates on any dividends and interest received because the CRA will deem any dividends and interest to be "unreasonable". Going to Tax Court to disprove that the amounts are unreasonable will be time consuming. Small business would have to keep "transfer pricing"[14] type documentation[15] to support dividend and capital gain payments for multiple years which is not practical and would take time away from running the business.

[12] The Personal Service Business rules effectively force the contractor to pay out the corporations' income as salary to ensure over-taxation does not occur.
[13] Bill Morneau, Editorial to the Global and Mail, September 5, 2017.
[14] The practice of determining pricing of goods and services between related parties on an "arms-length basis", typically with those related parties in another country.
[15] The definition of "split portion" 120.4(1) of the Income Tax is similar to 247(4)(v) of the Income Tax Act.

Also, any corporation with a sole shareholder will be caught be these rules if they are married. This result is clearly nonsensical.[16]

The rules do not factor in the following:

- The contribution of the "stay-at-home" spouse to help the other spouse build the business
- Family assets that are risked in starting a business
- Family law that require business to be split among spouses equally on divorce regardless of the direct contribution of the spouses

It should be noted that no other jurisdiction in the world applies a reasonableness test to receipt of dividend or capital gains. Given the numerous "tweets" issued by the Department of Finance comparing Canada to the other G7 countries promoting Canada as having the lowest tax rate for small business, bringing in these rules would be inconsistent with the objective of having a low tax rate for small business.

SPECIFIC COMMENTARY – PASSIVE INCOME

It is unclear why corporations should not be allowed to save assets in a corporation and why this is a "problem". The government's argument is that employees and business owners should be taxed the same. If that is the case, one must ask the question – why would anyone go into business? If two alternatives exist that offer the same return, as illustrated by the Proposals, the rational investor would earn / invest their money in the activity with the lower risk. In the case, the individual would be an employee and not an entrepreneur.

The government will ultimately receive the money deferred in a corporation at a later date, much like a RRSP or any other tax-sheltered plan. The current concept of integration works well and in fact it costs more in taxes to have money flow through a corporation than if the money was earned directly by an individual. The main tax benefit is deferral which the government allows through savings plans. Therefore, it is unclear why deferral of business income is "unfair" for entrepreneurs who take risk but deferral of investment income for employees is "fair".

Also, with the extra taxes being paid on investment income, money will be taken out of the economy which will slow growth. I will illustrate using an example based on one of my clients:

A landscaping company is run by four siblings who live off about $40,000 a year. The company is profitable and has been able to build up cash over time. While the business is stable, they do not want to invest outside of their geographical area. As such, they have chosen to invest in the stock market with an investment advisor and buy residential real estate in their area. The residential real estate requires extensive repairs before the houses can be rented out to middle class families. This housing activity keeps the employees of the landscaping company employed for an extra two months of the year. The passive income Proposals will do the following by removing money from the company: (a) the investment advisor and the bank will lose fees, (b) the company will not provide extra employment, and may cause job losses and (c) the company would not build the housing and the related activity that comes with the building of the homes.

[16] Supra footnote 1.

Also, it is unclear why non-CCPCs would be exempt from these rules. Why should a public company pay 26.5% taxes on interest income while a CCPC would pay 50.17% on the same interest income in Ontario? Or why should an investor pay only $55.41 in both corporate and personal taxes on $100.00 of interest income from a public corporation compared to $72.74 for the same $100.00 interest income earned in a CCPC?

You have recently stated[17] that excess investments are "dead money" but in earlier statements by yourself and the Department of Finance[18], business owners should not worry about their ability to save for their businesses. Are the excess funds "a rainy-day fund" or "dead money"?

I believe the non-fundable taxes from investment income will also discourage capital being raised from "angel investors/lenders" as shown in the example below based on another of my clients:

An advertising agency (a CCPC) has experienced rapid growth in the last four years that started with the 2 founders and now has over 20 employees. Many of agency's contracts are with very large corporations that require the agency to fund the expenses upfront for a campaign and then wait up to 90 days for payment after completion. The agency has exhausted all bank funding including the Business Development of Canada. Fortunately, one of the founders knows an owner of a successful CCPC and the owner of that CCPC has excess capital as the owner lives a frugal lifestyle and doesn't need the money from the company. The successful CCPC makes a loan to the advertising agency to help with cash flow. Without this loan, the advertising agency would have difficultly keeping up with its growth plans. However, these Proposals have made the successful CCPC think about calling the loan to prevent over 50% taxation on the interest income.

SPECIFIC COMMENTARY – CONVERSION OF INCOME TO CAPITAL GAINS

These Proposals clearly discourage members from passing a business from one generation to another. This is because more tax will be paid on a sale of the business to a family member rather than selling to a third party as selling to a family member will be taxed at a higher rate dividend rather than a capital gain where the capital gain deduction can be claimed. Proposed 84.1 will deny the cost base paid by the family member and the gain will be considered a deemed dividend. The rational investor will seek the highest return with the lowest risk which will cause the owner to choose to sell to a third party, likely a public for a foreign company.

Further, the guidelines provided for intergenerational transfers (if ever granted) are not practical. Another client situation is presented below:

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[17] Globe and Mail article, September 27, 2017 "Tax Changes will target 'dead money' and boost investment, Morneau says.

[18] For example, September 20, 2017, tweet by the Department of Finance reads: "Tax Fairness will maintain a business's ability to save and will protect its ability to invest…."

A father sold his business to his son via an estate freeze. Several years later, the son incurred an injury where he could not work for several weeks. The only person who could run the business was the father. Under the proposed guidelines, this transfer would not be a "genuine intergenerational transfer" because of the freeze shares and the fact father was participating in the management and operations of the business, even for a short-period of time.

The fact that 84.1 prevents "post-mortem" pipelines will lead to tax rates on death of over 80% across all provinces.[19] This tax rate cannot be considered "fair" under any circumstances.

Proposed 246.1 can be interpreted to apply in the following situations:

- Repaying of shareholder of loans could be considered a taxable dividend;
- Repaying of paid-up capital could be considered a taxable dividend; and
- Corporate owned life insurance proceeds received by CCPC could be considered a taxable dividend. Corporate life insurance needs to be specifically protected to ensure business owners pay the same amount of tax as individuals who own life insurance policies personally.

All of the transactions listed above are currently tax-free transactions and should remain tax-free transactions.

Please contact me at 289.813.4056 or 647.745.2250 to discuss the above or send your reply to myself at the address listed above.

Sincerely,

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[19] Is a 93% Tax Rate Fair to Canadian Small Business Owners? Michael Goldberg, with Mac Killoran and Jay Goodis, August 2, 2017.