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The Honourable Bill Morneau, P.C., M.P.  
Minister of Finance  
Department of Finance, Canada  
House of Commons  
Ottawa, Ontario K1A 0A6

**Sent Via Email**

Dear Minister:

**Re: Taxation of Private Corporations**

## I. INTRODUCTION

We write in response to the consultation paper released by the Department of Finance on July 18, 2017 (hereinafter the “**White Paper**”) relating to the taxation of private corporations. Our submissions below will address both policy-based and technical inconsistencies, defects and concerns relating to all three areas of focus identified by the Department of Finance, namely:

- Income splitting via dividends and capital gains, including capital gains deduction multiplication;
- Surplus stripping, defined for the purposes of the White Paper as the conversion of would-be dividend income into taxed or untaxed capital gains; and
- Passive investment deferral advantages for CCPCs,<sup>1</sup> primarily resulting from the differential between the corporate income tax rate for CCPCs eligible for the small business deduction and the top marginal personal income tax rate but also to a much smaller extent the differential between the general business corporate tax rate and the top marginal person tax rate.

<sup>1</sup> Being Canadian-controlled private corporations, as defined in subsection 125(7) of the *Income Tax Act* (the “**Act**”). All statutory references contained herein are references to the Act unless otherwise noted.

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## II. DISCUSSION

### 1. Income Splitting

#### (a) Tax Policy Contradictions

From a tax policy perspective, the soundness of the White Paper proposals relating to income splitting turns on one's opinion of the correct tax unit: if the correct tax unit is the individual, then the proposals may advance a reasonable tax policy objective; if the correct tax unit is the family, then the proposals are entirely inappropriate. Reasonable, informed people can and do disagree as to which tax unit ought to be preferred. The Department of Finance believes that the correct tax unit is the individual (for some purposes), while many or most non-government commentators who have made submissions as part of this consultative process believe that the correct tax unit is the family.<sup>2</sup>

Even if it is accepted that the correct tax unit is the individual, the current system is riddled with inconsistencies relating to the tax unit, creating the impression that the tax unit is a "heads I win, tails you lose" proposition. For example:

- *Means-tested benefits* – The Canadian tax system is used as a delivery mechanism for a variety of public benefits. Some of these benefits, including the GST/HST credit,<sup>3</sup> the Canada child benefit,<sup>4</sup> and the working income tax benefit,<sup>5</sup> are tied to household income or otherwise factor in the income of an otherwise eligible individual's spouse or common-law partner. If the correct tax unit is the individual, then these means-tested benefits delivered through the income tax system also represent a departure from the tax policy ideal.

As an aside, the departure from the individual tax unit appears particularly problematic in relation to means-tested benefits. The use of a family tax unit in these circumstances assumes a sharing of resources and income between family members and some degree of equality in bargaining power between higher-income spouses and lower-income spouses (who are typically, but not always, women). Household means testing can create gender-based inequalities, and seems inappropriate for programs targeted to low-income individuals.

- *Tax credit transfers* – Some tax expenditure benefits, such as the tuition tax credit,<sup>6</sup> the medical expense tax credit,<sup>7</sup> and the charitable donation tax credit,<sup>8</sup> may be transferred or assigned

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<sup>2</sup> These commentators frequently point to the analysis contained in chapter 10 of the Carter Commission Report: Canada, *Report of the Royal Commission on Taxation*, (Ottawa: Queen's Printer, 1966), Vol. 3, 117-151. This recommendation from the Carter Commission was not adopted as part of the 1972 tax reform. Other countries, including France, Germany and the United States, have historically used the household or family as the unit for personal income tax.

<sup>3</sup> Section 122.5.

<sup>4</sup> Section 122.6.

<sup>5</sup> Section 122.7.

<sup>6</sup> Section 118.8.

<sup>7</sup> Section 118.2.

between spouses or may be claimed by whichever spouse would realize the most significant tax savings from the tax expenditure benefit. In other words, the family unit has been selected as the appropriate tax unit for the purpose of incentivizing individuals to donate to charity or to obtain post-secondary education, and medical expenses are treated as a family expense while other expenses are not.

If the policy rationale for the assignment of the tuition tax credit is that it is appropriate to allow tax relief for persons who pay for the post-secondary tuition of their dependants (although we note that the assignment does not require any cash transfers), this may conflict with the conclusion that dividend income splitting with university-aged children is inappropriate. In effect, the controlling shareholders of private corporations who have university-aged children are obtaining similar – albeit potentially greater – tax benefits derived in part because of the tuition tax credits available to children whom they are supporting financially.

- *Pension income splitting* – Individuals who have attained the age of 65 are generally permitted to split pension income with their spouse, without any accompanying cash transfer and without any means-based qualifications. In our view, there is no principled tax policy reason for this departure from the individual tax unit for only a limited subset of individual taxpayers. If the rationale is to support low-income seniors, then there are other means-tested programs such as the guaranteed income supplement and old age security that would better achieve this objective.<sup>9</sup> If the rationale is to reduce tax on senior citizens relative to others due to their age, then this could be done explicitly through amendments to the age credit.<sup>10</sup>

Taken together, it is difficult for us to accept that, even if the individual is the correct tax unit, income sprinkling by private corporation shareholders using dividends and capital gains represents a marked departure from existing tax policy. If the Department of Finance is convinced that the individual tax unit is fundamental to Canadian tax law, then it would be useful for the Department of Finance to re-examine or explain why the aforementioned contradictions, among others, continue to persist.

## **(b) Legislative Issues**

The CBA-CPA Canada Joint Committee on Taxation has submitted a detailed list of technical issues relating to the income splitting proposals, and we believe that the concerns that they have identified are well-founded. We are particularly concerned that the adoption of a vague reasonability test in the proposed “split portion” definition in subsection 120.4(1) will introduce considerable uncertainty into the administration of the proposed rules, and that this uncertainty will likely lead to future litigation.

Moreover, and as noted in other submissions, the proposed amendments to section 120.4 are overly complicated relative to the tax that is being avoided and increase compliance obligations for most

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<sup>8</sup> Section 118.1.

<sup>9</sup> See Parts I and II of the *Old Age Security Act*.

<sup>10</sup> Subsection 118(2).

owner-managed businesses. Subsequent to 1998,<sup>11</sup> it has been standard practice (at least in Alberta) for corporate lawyers and accounting firms to incorporate owner-managed businesses with both the owner-manager and their spouse as shareholders, and often to include adult children as shareholders. Consequently, it is not only the highest-earners who are confronted with the problem of complying with the proposed amendments, but also a very large number of smaller firms whose shareholders are likely not top marginal rate taxpayers.

We question the fairness of the proposed rules given that they result in tax payable at the top marginal rate even in circumstances where there is no other person in existence from whom income is supposedly being “split” or where there is such another person but that other person is not at the top rate. The proposals are certain to result in punitive levels of taxation for any middle class families to which the rules might apply.

We further question whether the public interest might be better served by simply amending the definition of “specified individual” in section 120.4 include individuals who have not yet attained the age of 25 years before the year. Again, and as noted in other submissions, this would significantly reduce complexity and compliance costs, would be simple for taxpayers and their advisors to understand, and would eliminate the most significant income splitting benefits. While individuals aged 18-24 may work in an incorporated owner-managed business, the scope for inappropriate application of the rules would at least be contained to that demographic.

## **2. Surplus Stripping**

### **(a) Proposed Amendments to Paragraph 84.1(2)(a.1)**

The proposed amendments to paragraph 84.1(2)(a.1) would render ACB “soft” for the purposes of section 84.1 to the extent of any capital gain realized by a non-arm’s length person, even where tax is paid. This proposed amendment appears to be intended to prevent “pipeline” transactions, which are intended to allow for the extraction of corporate assets at capital gains rates (currently up to 24% in Alberta) versus dividend rates (currently up to 31.71% or 41.29% in Alberta, depending on whether or not the dividend is an eligible or non-eligible dividend).

From our perspective as Alberta tax practitioners, this amendment appears to be necessitated in large part by recent provincial and federal income tax rate increases.<sup>12</sup> Prior to 2015, the top income tax rate payable by an Alberta-resident individual on capital gains was 19.5%, while the top Alberta eligible dividend rate was 19.29% and the top Alberta non-eligible dividend rate was 29.36%. At these rates, there was a penalty for undertaking a pipeline transaction where the private corporation had the ability to pay eligible dividends, while the rate differential between capital gains and non-eligible dividends was not sufficiently large to justify the costs of smaller pipeline transactions. Returning

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<sup>11</sup> Following the release of the Supreme Court of Canada’s decision in *Neuman v. M.N.R.*, [1998] 1 S.C.R. 770 (S.C.C.), reversing 96 D.T.C. 6464 (Fed. T.D.), reversing 94 D.T.C. 6094 (Fed. T.D.), affirming 92 D.T.C. 1652 (T.C.C.).

<sup>12</sup> Specifically, the addition of the new 33% federal income tax bracket for incomes over \$202,600, and the four new Alberta income tax brackets for incomes over \$151,951.

income tax rates to their 2014 levels would go a long way toward solving this problem, although we recognize that the Department of Finance has no control over provincial income tax rates.

If enacted, the effect of proposed paragraph 84.1(2)(a.1) would be to significantly increase the tax cost of an *inter vivos* sale of shares between members of a family – a common occurrence in situations where owner-managers wish to transfer a business to their children but do not have sufficient resources to fund their retirement without receiving consideration. Were the sale to occur at arm's length, the buyer, which would likely be a corporation, could acquire the shares in exchange for debt and then amalgamate with the target corporation, and thereafter repay principal and interest using business profits (and while claiming an interest deduction against business income).<sup>13</sup> Absent any amendment to paragraph 84.1(2)(a.1), related individuals could implement similar transactions at a comparable tax cost by acquiring the shares personally and then transferring the shares to a newly-incorporated corporation in exchange for debt.<sup>14</sup>

By denying an increase to the ACB of shares for the purposes of section 84.1, proposed paragraph 84.1(2)(a.1) will require children to pay the purchase price of the shares using cash that has been distributed to them personally by the target corporation. The implication is that the profits that the business must generate to service the same debt following a non-arm's length sale may need to be up to 184% higher than following an arm's length sale.<sup>15</sup> It would be reasonable to expect that the increased debt service costs would translate to non-arm's length buyers being able to offer lower prices for family businesses than arm's length buyers, and will therefore impose an economic cost on owner-managers who wish to keep family businesses in the family.

The treatment of non-arm's length share purchasers is especially problematic because a sale within a related group will not result in an acquisition of control of the target corporation,<sup>16</sup> and will therefore not allow for a "bump" of the tax cost of the non-depreciable capital assets of the target corporation.<sup>17</sup> In effect, the only way that the non-arm's length share purchaser can receive any tax recognition for the amounts that they will pay to acquire their shares will be on an arm's length sale of the shares of the target corporation. This is far more restrictive than the tax treatment of an arm's length share purchaser, and we do not see any reason for this differential treatment.

We acknowledge that the Department of Finance is aware of this concern and is studying potential solutions. Given the significant impact that this proposed amendment will have on succession planning for owner-manager business while solutions are being studied, it seems irresponsible for the Department of Finance to have proposed that amended paragraph 84.1(2)(a.1) would come into effect

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<sup>13</sup> Pursuant to paragraph 20(1)(c).

<sup>14</sup> We assume that the share vendor would not claim a capital gains deduction in these circumstances.

<sup>15</sup> Assuming that CCPC business income that would be used by an arm's length buyer to repay the debt is taxed at a combined federal-provincial rate of 12.5%, and assuming that the personal income used by a non-arm's length buyer to repay the debt would be taxed at a combined federal-provincial rate of 48%.

<sup>16</sup> Within the meaning in subsection 256(7), provided that the non-arm's length persons acquiring *de jure* control are "related" to the vendors within the meaning in subsection 251(2).

<sup>17</sup> Pursuant to paragraphs 88(1)(c) and (d).

on the announcement date. In the future, we suggest that draft legislation for proposals with so glaring a deficiency not be released until after workable solutions have been identified.

Furthermore, the requirement to track ACB generated by non-arm's length capital gains from 1984 to the date of any relevant disposition is cumbersome and will complicate a wide variety of transactions. While a similar requirement has historically existed in the current paragraph 84.1(2)(a.1) in relation to prior capital gains deduction claims, that requirement was effective only in respect of dispositions after the enactment of paragraph 84.1(2)(a.1), meaning that taxpayers were aware of the requirement to track length capital gains deduction claims by non-arm's length persons and had the opportunity to create records. It is possible that adequate records may not exist, since now-deceased taxpayers could not have anticipated this amendment.

The proposed amendment to paragraph 84.1(2)(a.1) will also preclude *post mortem* pipeline transactions, which we anticipate will have a significant negative effect on estate administration. Pipeline transactions are routinely undertaken by estates in order to distribute assets of a private corporation because the trustees of a graduated rate estate have missed the deadline for a capital loss carry-back following a repurchase of shares owned by the decedent.<sup>18</sup> Such a repurchase must be completed within the first taxation year of the graduated rate estate, and it is common for estate trustees – especially if they are not lawyers, accountants or professional trustees – to miss this deadline. A pipeline offers the opportunity for estate trustees who find themselves in this situation to avoid the double tax that would otherwise result if the corporation were to repurchase shares or pay dividends.

We do not expect that the effect of an amendment to paragraph 84.1(2)(a.1) will be to make estate trustees more diligent. Rather, we expect that the effect of precluding *post mortem* pipeline transactions will be to increase litigation against estate trustees who miss the loss carry-back deadline, and to decrease the willingness of knowledgeable individuals to serve as estate trustees. The result will be increased costs for decedents and estates, whether in the form of double taxation, increased legal fees or fees paid to professional trustees.

This problem could be reduced by extending the loss carry-back period for shares repurchased from a graduated rate estate so that any capital loss so realized by an estate at any time that it is a graduated rate estate may be applied against the decedent's capital gain in respect of those shares. An extension of this deadline is long overdue, and is required to preserve a sense of fairness in the event that the proposed amendments to paragraph 84.1(2)(a.1) proceed.

As a final observation, we note that the White Paper correctly identified that when section 84.1 applies the result typically is double taxation, because the same economic gain is taxed twice: once as a capital gain and once as a dividend. However, the White Paper states that "[t]his is consistent with discouraging taxpayers from entering into schemes that seek to avoid section 84.1." If section 84.1 only applied in circumstances that were abusive, the comment in the White Paper might be justified. However, as almost any tax practitioner is aware, this provision is frequently engaged inadvertently and innocently. The proposals to expand the scope of section 84.1 will vastly increase the

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<sup>18</sup> Under subsection 164(6).

circumstances in which it applies to innocent parties, and will result in a significant increase in incidences of inappropriate double-taxation. We submit that the comment in the White Paper is likely to be considered offensive to anyone who is familiar with how this rule works in practice.

**(b) Proposed Section 246.1**

The CBA-CPA Canada Joint Committee on Taxation has submitted a detailed list of technical issues relating to proposed section 246.1, and we echo their concerns.

In its current form, proposed section 246.1 is vague and uncertain. Its broad and open-ended language, combined with the recurring use of the phrase “directly or indirectly” and the choice of unusual words (such as “disappearance”), makes it very difficult for practitioners or taxpayers to determine when a transaction is described by subsection 246.1(2). Although used to describe another anti-avoidance rule,<sup>19</sup> the following quote from Judge Bell is equally apt in relation to proposed section 246.1:

A provision in a self-assessing taxation system should be clear and capable of ready comprehension. Subsection 129(1.2) falls short of this standard. Subsection 129(1) entitles a taxpayer to a dividend refund on the payment of taxable dividends. Subsection 129(1.2) disentitles a taxpayer to such refund without any description of circumstances justifying that result. The Court should be able to interpret legislation and to apply it to the facts without the task of having to divine meaning from an assemblage of words whose intended objective could hardly be better disguised. In such circumstance the Court must reluctantly resort to other materials in an effort to glimpse the creature concealed.<sup>20</sup>

Both practitioners and taxpayers are quite concerned that the low “one of the purposes” threshold and the difficulty of identifying when an amount might be received indirectly from a person who may or may not be factually at arm’s length with a taxpayer means that ordinary commercial transactions may inadvertently be caught. For example, since the release of the White Paper, we have been asked by other tax practitioners to opine on whether section 246.1 might apply to the following types of transactions that are clearly not examples of surplus stripping:

- A taxable sale of business assets by a CCPC to an arm’s length party prior to July 18, 2017, where the CCPC did not pay corresponding capital dividends prior to July 18, 2017;
- A taxable sale of business assets by a CCPC controlled by an individual to a CCPC controlled by the individual’s sibling, as part of a business transition;
- An internal transaction to realize accrued capital gains on assets prior to a “safe income determination time”<sup>21</sup> that would occur as part of a series of transactions in which the assets were sold to an arm’s length buyer;

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<sup>19</sup> Subsection 129(1.2).

<sup>20</sup> *Canwest Capital Inc. v. R.*, 97 D.T.C. 1 (T.C.C.), at paragraph 21.

<sup>21</sup> As defined in subsection 55(1).

- A divisive reorganization of a family business controlled by two siblings, undertaken on a taxable basis since no exception to subsection 55(2) would have applied;
- A taxable sale of appreciated capital assets by a CCPC with non-capital losses to a third party purchaser, followed by the payment of a capital dividend by the CCPC; and
- A taxable sale by a CCPC of the shares of its wholly-owned subsidiary, followed by the payment of a capital dividend by the CCPC.

A well-drafted anti-avoidance rule should not be so potentially broad in its application that even tax practitioners feel compelled to seek opinions from expert tax counsel as to the possibility of the anti-avoidance rule applying to commercial transactions that are outside of any defensible legislative rationale.

We recommend that the Department of Finance identify the types of abuse that it intends for section 246.1 to address, and re-draft subsection 246.1(2) in order to actually target this abuse. At an absolute minimum, and to provide additional certainty for taxpayers engaging in *bona fide* commercial transactions, we recommend that the “one of the purposes” test in subsection 246.1(2) be changed to a “principal purpose” or “one of the main purposes” test.

### **3. Passive Investment Proposals**

#### **(a) Consumption vs. Income Taxation**

For most Canadians, the income tax resembles a consumption tax. Substantially all household savings for most Canadian families are invested in RRSPs and principal residences. Most households do not make the maximum possible RRSP contribution, suggesting that any income subject to tax is being used to finance consumption or to pay for a principal residence. Investment returns from RRSPs are not taxed until amounts are withdrawn from the RRSP to finance current consumption, while investment returns from principal residences are never taxed.

Viewed in this light, what the shareholders of private corporations are accomplishing through the deferral of personal income tax is similar to what most Canadians are able to accomplish, albeit with potentially greater amounts but at the price of far less generous tax treatment. The deferred income that is reinvested by the corporation will be subject to personal income tax when distributed by the corporation to finance shareholder consumption, and the corporate savings are a substitute for maxed-out RRSP contributions. Investment returns are subject to tax, generally at or near the top integrated corporate-shareholder rate.

The shareholders of private corporations are synthesizing an outcome that is available to most Canadians, rather than one that is not. Realistically, most Canadians who earn enough for their investments returns to be subject to income tax when those returns are realized have taken advantage of the opportunities afforded by a private corporation, so there is not a horizontal equity problem. To the extent that there is a difference in taxation between persons with different incomes, the difference is only that the private corporation shareholders earn more and are thus in a position to save more; the result that savings are not subject to full-rate personal income tax is not conceptually different.

If the Department of Finance is determined to move forward with the proposed regime for taxing passive income, a reasonable inducement might be to significantly increase RRSP and TFSA contribution limits. This would help address the perceived horizontal equity issue, while also ensuring that savings continue to be tax-preferred to some degree regardless of top-line income.

**(b) Foreign Alternatives**

Most developed nations have a significant gap between their corporate income tax rates and personal income tax rates. Other nations should therefore be expected to have either: (a) a comparable regimes to address the deferral benefit from earning income through a private corporation; or (b) considered the issue relating to the deferral benefit and passive investment by private corporations and concluded that the problem is not significant enough to warrant a legislative response.

We were disappointed that the White Paper did not attempt to compare the assets and investment income of CCPCs with the assets and investment income of private corporations in foreign jurisdictions, and did not canvas how the other jurisdictions have addressed the deferral benefit. Such comparisons would have been instructive: if similarly-situated jurisdictions have declined to take action to address the deferral benefit or have taken no action but have less concentrated investments in private corporations, then the Department of Finance could explain why Canada is unique; if similarly-situated jurisdictions have regimes to address the deferral benefit, the Department of Finance could have examined whether one of those regimes could be redesigned for use in Canada.

If the Department of Finance did in fact consider foreign jurisdictions and foreign regimes, we recommend that the Department of Finance release a discussion of these foreign alternatives as a supplement to the White Paper. Doing so would certainly help to justify or contextualize the proposed changes to the passive investment regime, which appears to be unduly complicated relative to its uncertain benefits for Canadians collectively.

**(c) The Apportionment Method is Unduly Complex**

Based on the discussion in the White Paper, it appears that the implementation of the apportionment method for passive investment income would require, among other things, the following:

- The retention of the current regime for taxing passive investment income earned by a CCPC, which would continue to apply to income earned from grandfathered capital and to corporations that have made the contemplated investment corporation election.
- Tax pools for retained earnings based on whether the earnings are attributable to income subject to tax at the small business deduction rate, income subject to tax at the general corporate income tax rate, shareholder contributions, income subject to tax in a foreign jurisdiction, or passive investment income, or retained earnings existing prior to certain events such as an acquisition of control of the private corporation.
- Rules relating to income generated using capital that can be traced to a loan from either an individual shareholder, another non-arm's length corporation or a financial institution.

- Rules for allocating losses between various tax pools and sources of income, so as to prevent business losses from being used to reduce investment income or *vice versa*.
- Updated rules for the classification of amounts paid between private corporations as either active business income or passive income. Examples might include: a review of the appropriate threshold for re-classification of interest or rents deductible in computing the business income of one corporation as business income of the recipient;<sup>22</sup> and the classification of inter-corporate dividends based on the tax pools of the dividend payer and dividend recipient.<sup>23</sup>
- Rules for determining whether capital assets are “good” assets, a capital gain from the disposition of which will result in a capital dividend account (“CDA”) addition, and “bad” assets, a disposition of which will not result in a CDA addition. It will also be necessary to identify a shareholding threshold in order for investments in another corporation to potentially be a “good” asset, and for measuring whether the asset mix of the other corporation is sufficient for the shares to be a “good” asset.
- A codification of the common law test for distinguishing between investment assets held for business purposes versus investment purposes,<sup>24</sup> in order to reduce litigation relating to working capital requirements, etc.

In effect, the Department of Finance is proposing to enact a version of the foreign affiliate surplus rules that will apply to Canadian-resident private corporations.<sup>25</sup> These rules are widely viewed as being among the most complicated in the Act, and are well understood by only a small subset of tax practitioners. Having to comply with similar domestic rules would either impose an unreasonable compliance cost on smaller private corporations, or would result in non-compliance resulting from professional advisors basing advice on their understanding of the spirit of the rules rather than a solid technical understanding of the applicable statutory provisions.

Unfortunately, of the two alternatives proposed by the Department of Finance, the apportionment method is likely to be the only one that is feasible in practice. The fact that such a complex regime is necessary to achieve the Department of Finance’s objectives, and will raise an unquantified amount of revenue and have an undetermined effect on the inequality of wealth distribution, should give the Department of Finance pause in concluding that the benefits of these proposals exceed their costs.

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<sup>22</sup> As in subsection 129(6) or paragraph 95(2)(a). In our view, the “associated” threshold in subsection 129(6) is too high, and would need to be replaced with something similar to the “foreign affiliate” threshold used in subparagraph 95(2)(a)(ii).

<sup>23</sup> To some extent, this is done already using Part IV tax. However, since Part IV tax would presumably become non-refundable as part of the new regime, in our view the “connected” threshold in subsections 186(2) and (4) is inappropriate.

<sup>24</sup> *R. v. Ensite Ltd.*, [1986] 2 S.C.R. 509 (S.C.C.), affirming 83 D.T.C. 5315 (F.C.A.), reversing 81 D.T.C. 5326 (Fed. T.D.).

<sup>25</sup> See Part LIX of the *Income Tax Regulations* and section 95 of the Act.

**(d) The Elective Method is Too Simplistic**

While superficially more attractive than the apportionment method, the elective method discussed in the White Paper is unlikely to be workable in practice. Moreover, since many of the transitional rules, character preservation rules, etc., will still be required, it is unlikely that the elective method will prove to be substantially simpler than the apportionment method.

The elective method assumes that shareholder contributions will not be used to earn passive investment income. It is unclear why the Department of Finance believes that this assumption is sound, other than that it removes the need for a shareholder contribution pool. We believe that this assumption would need to be revisited were this regime to be implemented, as it is entirely possible that passive income can be traced to shareholder contributions or otherwise allocated to shareholder contributions.

The elective method also assumes that private corporations electing to preserve the small business deduction will predictably earn less than \$500,000 of taxable income annually; if not, these corporations would have to pay tax at the general corporate rate on the excess, but shareholders would not receive credit for the tax paid at the higher rate when determining whether dividends would be taxed as eligible or non-eligible dividends. The practical effect of this shortcoming is that owner-managers would have to maintain two private corporations: an electing small business deduction corporation to earn income up to \$500,000, and an electing general rate corporation to earn income over \$500,000. The multiplication of corporations carrying on substantially the same business in order to avoid harsh side effects of the elective regime will lead to inefficiency and deviates from the neutrality principle.

Another drawback of the elective method is its potential unfairness for corporations whose entitlement to the small business deduction is uncertain. Examples include a corporation that may or may not carry on a personal services business depending on the facts relating to its relationship with its main client, a corporation that may carry on a specified investment business depending on how many hours its employees work in a particular year, or a corporation that may or may not be subject to *de facto* control by non-residents. If these corporations were to elect to maintain their small business deduction but were subsequently determined to be ineligible, the corporations and shareholders will be overtaxed. If the corporations elect to be non-CCPCs in order to avoid the risk of over-taxation, then uncertainty may be causing them to forego the tax benefits intended by Parliament.

This last problem would be partially mitigated by permitting corporations to re-elect on an annual basis and to retroactively re-elect in respect of a particular taxation year if the small business deduction is disallowed by the CRA or a court. However, we suspect that the Department of Finance intends any election to be permanent or near-permanent in the same manner as the existing non-CCPC election,<sup>26</sup> so this potential unfairness may be an intractable shortcoming of the elective method.

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<sup>26</sup> In subsection 89(11).

**(e) The Proposed Regime Will Lead to Aggressive Behaviour and Litigation**

Provided that the Department of Finance does not intend to codify many of the interpretive rules or common law tests that are relevant to the existing regime for the taxation of CCPC investment income, the proposed regime will likely result in additional tax controversies. Due to the significant tax penalty that will be imposed on investment income versus active business income, taxpayers will be incentivized to seek shelter in the “grey areas” that will persist.

For example, consider the following:

- As noted above, private corporations will often hold marketable securities, interest-bearing debts, etc., as part of their working capital. The income from these securities should not be investment income so long as the securities are used or risked in the business because of working capital requirements. Firms will be strongly incentivized to take the position that their working capital requirements are larger than what might be expected absent this tax-related distortion.
- Whether or not a corporation carries on a specified investment business depends in part on whether or not more than 5 full-time employees are engaged in that business. Corporations will have an incentive to attempt to allocate as many employees as possible to the potential specified investment business, while also manipulating hours worked and part-time vs. full-time status (which is undefined) in order to avoid the existence of a specified investment business. In some cases, firms may seek to hire employees in excess of commercial requirements, and less scrupulous firms and individuals seeking to accrue employment insurance benefits may engage in a fraudulent *quid-pro-quo*.
- A corporation may carry on a single business or may carry on two or more businesses, one of which might be a specified investment business. In situations where it is not perfectly clear that a potential specified investment business is a separate business (e.g. a firm that engages in both real estate development and real estate leasing), firms will be strongly incentivised to rely on even tenuous links between the business to file their returns on the basis that there is a single, active business being carried on.

There is little downside to taking potentially aggressive filing positions of this nature. The flexibility of the common law means that, barring fraud, corporations should be able to identify a sufficient legal basis for almost any considered filing position, so that any penalties assessed by the CRA are likely to be vacated by the Tax Court of Canada. It is also unlikely that the CRA will have sufficient recourse to detect, audit and reassess all aggressive positions, and taxpayers may be further emboldened should any reassessed taxpayers succeed in an appeal to the Tax Court of Canada.

While similar incentives arguably exist in relation to the existing regime, the integrated taxation of investment income means that the incentive is much smaller. Taking a more cautious filing position means that corporate investment income is taxed, on a fully-integrated basis, at effectively the same rate as personal investment income. This result does not appear particularly unfair to taxpayers. Under the proposed new regime, the non-refundable tax on corporate investment income would result

in significant non-integration and a tax cost far in excess of the rate applicable to personal investment income, resulting in an effective penalty for cautious taxpayers.

**(f) Treatment of Capital Gains**

The White Paper is not clear on whether or not capital gains realized on the disposition of business assets will generate CDA; indeed, the suggestion seems to be that such gains will not generate CDA, if the assets were acquired with reinvested business income. With respect, this is a punitive result that does not accord with the Department of Finance's stated rationale for the small business deduction or the general rate reduction, *i.e.* to allow for reinvestment in the business. If gains on business assets are to be taxed in the same manner as gains on investment assets, then the incentive to reinvest in the business rather than to acquire passive investments and engage in tax planning is much weaker.

The Department of Finance's current thinking is that a capital gain realized on a disposition of shares of another corporation would generate CDA if the other corporation was controlled<sup>27</sup> by the disposing corporation and if the assets of the other corporation were used "exclusively" in its active business. With respect, neither of these thresholds is practical. A control requirement would generate punitive results when two or more arm's length private corporations go into business together through a third corporation that is not controlled by any investor corporation or that is controlled by only one of them. Second, most private corporations will have at least some *de minimis* assets that are not held for use principally in the corporation's active business.

We suggest that a more realistic approach would be to set a threshold for acceptable investments in other private corporations that is far below the control requirement, while still requiring substantial shareholdings. An example could be the "connected" requirement used for the purposes of Part IV tax, or the ownership threshold required for a foreign corporation to be a foreign affiliate of a Canadian corporation.<sup>28</sup>

With respect to asset mix, we believe that a pragmatic approach would be to adopt a requirement similar to the requirement for a share of a foreign affiliate to be an "excluded property" of another foreign affiliate: at the disposition time, all or substantially all of the value of the assets of the other corporation must be attributable to assets used principally for the purpose of producing income from an active business.<sup>29</sup> The use of the "all or substantially all" threshold rather than an "exclusively" threshold should create the leeway needed to accommodate real-world situations while still achieving the Department of Finance's stated objectives.

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<sup>27</sup> We assume that this is a reference to *de jure* control, being the right to appoint the majority of the board of directors by virtue of owning the majority of voting shares: *Duha Printers (Western) Ltd. v. R.*, [1998] 1 S.C.R. 795 (S.C.C.) at paras. 35-36, reversing 96 D.T.C. 6323 (F.C.A.), reversing 95 D.T.C. 828 (T.C.C.); *Buckerfield's Ltd. v. M.N.R.*, 64 D.T.C. 5301 (Can. Ex. Ct.) at para. 10.

<sup>28</sup> See the definition of "foreign affiliate" in subsection 95(1).

<sup>29</sup> See the definition of "excluded property" in subsection 95(1).

**(g) Aspects of the Proposals Lack Sufficient Detail**

The White Paper contemplates that the existing regime for refundable taxes on investment income will be preserved and applied to corporations whose investment assets are acquired using shareholder investments, and that some form of “grandfathering” will apply to income from existing capital. We do not believe that sufficient detail has been provided to allow for meaningful comment in relation to either of these aspects of the proposed regime.

We do observe, however, that any transitional rules for existing investments will likely need to apply to the existing capital pool of a private corporation rather than the particular assets of the private corporation. Limiting the application of transitional rules to only particular assets held on a particular date would enhance capital lock-in effect and would provide a meaningful tax incentive for taxpayers to remain invested in less productive assets. While transitional rules based on a capital pool will be more difficult to draft and to apply, this difficult drafting does appear to be necessary.

**(h) Extension to Non-CCPC Private Corporations**

The Department of Finance has indicated that it is studying the extension of either the existing refundable tax regime for CCPC investment income or the proposed non-refundable tax regime to private corporations that are not CCPCs. We believe that any legislation implementing such an extension will have to be drafted narrowly in order to avoid adverse impacts on inbound non-resident investment in Canada, and, in the case of a refundable tax regime, to avoid tax revenue losses.

As noted by the CBA-CPA Canada Joint Committee on Taxation, the rationale for not extending the refundable tax regime for CCPC investment income to non-CCPC private corporations was that more tax revenue could be generated from taxing that investment income at the general corporate rate. This was because Canadian income tax payable at the general corporate rate plus Part XIII withholding taxes on future dividends paid to the non-resident should exceed the non-refundable corporate tax on CCPC investment income plus withholding taxes on dividends paid to recover refundable taxes.<sup>30</sup>

For example, assume a non-resident controlled private corporation were to invest in real estate located in Alberta. Under existing law, any rental income earned by the private corporation would be subject to tax at a combined Canada-Alberta rate of 27%, plus Part XIII withholding tax equal to, say, 5% of the gross amount of any dividend paid in the future.<sup>31</sup> If the current regime for taxing CCPC investment income were to be extended to this non-resident controlled corporation, rental income earned by the private corporation would be subject to post-dividend refund corporate income tax at a combined Canada-Alberta rate of 20%, plus Part XIII withholding tax equal to 5% of the gross amount of dividends paid in the current taxation year.

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<sup>30</sup> In all likelihood, these dividends would be paid in the current taxation year in order to recover the refundable portion of the private corporation’s tax payable, in accordance with subsection 129(1).

<sup>31</sup> Assuming that the non-resident shareholder is a corporation resident in a country with which Canada has a bilateral tax treaty and that the non-resident corporation owns more than 10% of the voting shares of the Canadian private corporation.

However, notwithstanding the potential Canadian tax revenue loss, a non-resident investor's effective tax rate could *increase* if subjected to the CCPC investment income regime. This is because the non-resident investor's country of residence will likely impose tax on any dividend that is paid by the Canadian private corporation in order to recover refundable taxes and received by the non-resident.<sup>32</sup> Under the existing regime, any residence country tax on dividends can be deferred indefinitely. The consequence of any amendment affecting non-residents is therefore to increase the effective tax rate on non-resident investment in Canada, which should have a corresponding negative effect on the willingness of non-residents to invest in Canada.

The negative effect on non-resident investment in Canada would be increased further if the proposed non-refundable tax regime were to be imposed on non-resident controlled private corporations. Returning to our prior example, the combined Canada-Alberta non-refundable corporate income tax rate would be 50.67%, plus withholding tax of 5% of the gross amount of dividends paid to a non-resident shareholder in future taxation years. This is clearly not an internationally competitive tax rate on mobile capital income, and would be made more uncompetitive yet if the shareholder's country of residence imposed any additional taxes on dividends received.

Any extension of the existing refundable tax regime or the proposed non-refundable tax regime for CCPC investment income to non-CCPC private corporations will need to be very carefully implemented to distinguish between non-resident controlled private corporations and other private corporations. The failure to distinguish between non-resident private controlled corporations and other private corporations will have a significant and harmful effect on Canada's ability to attract foreign investment.

Moreover, if the Department of Finance seeks to levy tax specifically on non-resident controlled private corporations, we question whether such an attempt would be viewed by Canada's treaty partners as a violation of ant-discrimination provisions contained within those treaties. Worse yet, this could lead to our treaty partners imposing additional taxes on Canadians investing in those countries.

If a change to the taxation of non-CCPC private corporations were to be made, however, we note that the White Paper assumes a combined rate of federal and provincial tax that is materially lower than the actual combined tax rate in Alberta and, indeed, in most provinces. As a result of using a hypothetical tax rate that is not representative of actual tax rates payable by most Canadians, the magnitude of the perceived problem is greatly overstated. Further, although the proposed solution purports to achieve neutrality between business owners and employees, in actual fact it would result in significantly greater tax burdens on business owners relative to employees.

#### **(i) The Proposed Non-Refundable Tax Rate Is Too High**

The proposed non-refundable 38 2/3% non-refundable federal income tax rate that will be applicable to investment income earned by a private corporation supposes that any shareholder of a private

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<sup>32</sup> We acknowledge that it might be possible to take a corporate step that is treated as a dividend for Canadian income tax purposes (such as increasing the stated capital of shares so as to cause a deemed dividend equal to the stated capital addition pursuant to subsection 84(1)) and that might be disregarded in the shareholder's country of residence, but this will not always be a solution if the tax laws of the non-Canadian jurisdiction would recognize the deemed dividend.

corporation would be taxed at the top federal marginal income tax rate. Combined with provincial corporate income taxes, the overall non-refundable tax rate applicable to investment income could be considerably in excess of the rate of tax applicable to investment income earned by an individual who is not subject to tax at the top federal income tax rate.

The assumption that the shareholders of private corporations with passive investment income are necessarily top marginal rate taxpayers is faulty. It is not necessarily the case that these individuals have made the maximum RRSP or TFSA contributions prior to deciding to retain or reinvest income in the private corporation. As an example, the shareholders of the corporation may wish to invest in a particular asset, such as rental real estate, that is not a qualified investment for RRSPs or TFSAs. The decision to acquire this non-qualifying asset is already less tax advantaged than acquiring a qualified investment through an RRSP, and there is no obvious reason why an individual who prefers a non-qualified investment should be subject to an additional tax burden.

While it may be that individuals not subject to tax at the top federal rate are not the shareholders of the CCPCs that earn the lion's share of investment income earned by private corporations, imposing a punitive rate of tax on these individuals is nevertheless unfair and represents (another) departure from the integration principle. We recommend that any proposal that is adopted include some measure to ensure that the rate of non-refundable corporate income tax applicable to passive investment income does not exceed the tax that would have been payable had the shareholders of the corporation earned that income directly.

#### **(j) The Proposed Regime Can and Will Be Defeated Through Tax Planning**

Based on the comments in the White Paper relating to the investment corporation election and grandfathering of existing investments, it appears likely that the existing provisions relating to the refundable tax regime for investment income will remain in the Act for the foreseeable future. This means that it should be possible for any political party to credibly promise to repeal the proposed regime and revert to the existing refundable tax regime. Consequently, we believe that taxpayers will seek to invest future CCPC earnings in a manner that defers or avoids the realization of passive investment income until such time as the proposed regime is no longer in effect.

There are a number of alternatives available to private corporations whose shareholders wish to engage in such planning, including the following high-level examples:

- Private corporations wishing to invest in marketable securities could acquire shares of public corporations which offer a reasonable prospect of capital appreciation and which either do not pay dividends or infrequently pay dividends. Securities of this sort would include shares of Amazon.com, Inc., Berkshire Hathaway, Inc., Alphabet, Inc., or Air Canada.
- Private corporations could elect to use profits to reduce debt ahead of schedule rather than investing in new assets, thereby increasing the net worth of the shareholders without generating investment income. While deleveraging would reduce interest deductions claimed, thereby increasing corporate earnings, those earnings would most likely be in the form of income from an active business that is not subject to the proposed regime.

- Retained profits could be invested in assets that will generate business income rather than passive investment income, either because of the nature of the property acquired or because the investment will constitute an adventure or concern in the nature of trade. Some types of investments or activities would include:
  - House “flipping” (*i.e.* acquiring, renovating and reselling within a short period of time, and without renting the housing unit), or investing in real estate development activities as a passive investor in a partnership or joint venture. These are somewhat risky activities that ought not to be tax-preferred. Moreover, it is possible that increased house flipping could have a noticeable effect on Canadian housing prices, with the result that tax policy will contribute to the frustration of other relevant economic policies.
  - Acquiring working interests in oil and gas properties. This is a very high risk investment category, and it is not obvious that non-professional investors should be provided with a tax incentive to acquire such interests.
  - Investing in partnerships that originate and acquire portfolios of financing leases for personal property.<sup>33</sup> Consumer debt of this variety is an extremely risky investment type, as most of the lessees are not sufficiently creditworthy to qualify for loans from mainstream financial institutions. It goes without saying that this sort of investment should not be tax-preferred relative to a safer asset class.
  - Acquiring units of widely-held partnerships that are not “SIFT partnerships”,<sup>34</sup> which could carry on any variety of businesses. The classification of the income allocated to the investor private corporation by the partnership would be based on the activities of the partnership, regardless of how large or small an interest is acquired.
- Private corporations could take advantage of any exception to the proposed regime for reinvestment in the corporation’s business or for shares of another private corporation representing a significant interest in that other corporation, regardless of whether or not such an investment would be advisable in a tax-neutral environment. In our view, an incentive for tax-motivated investments in small businesses that do not make sense based on anticipated pre-tax returns encourages business owners to place too great a portion of their savings at risk.

These are only a handful of the less aggressive options to defeat the proposed regime for taxing investment income, having regard for the details provided and both specific anti-avoidance rules and the general anti-avoidance rule. The point we wish to make is that ensuring that the proposed regime has any degree of integrity will require consequential amendments to dozens of unrelated provisions of the Act, which could impact millions of other taxpayers to varying degrees. Given the questionable ends that the Department of Finance is seeking to achieve, these means cannot possibly be justified.

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<sup>33</sup> Unlike most businesses of earning income from leasing activities, the income from leasing of personal property is not included in computing a CCPC’s income from a “specified investment business” as defined in subsection 125(7).

<sup>34</sup> As defined in subsection 197(1).

**(k) Conclusions on Investment Income**

We acknowledge that the Department of Finance is striving to create a more theoretically perfect income tax system. Like most utopian visions, however, the practical difficulties associated with these proposals for taxing the investment income of private corporations will render the regime unworkable. The implementation of the proposed regime will either require byzantine rules that will cause compliance costs to exceed the financial capabilities of most private corporations, or will involve simplistic rules that will create unfairness and encourage tax planning.

At this point in time, it may be necessary for the Department of Finance and its provincial counterparts to accept that the build-up of investment assets in private corporations is the obvious and foreseeable result of the last several decades of Canadian tax policy. Striving to adopt internationally competitive corporate income tax rates – including allowing all types of businesses to access the small business deduction – while raising or maintaining personal income tax rates, creates an obvious incentive to earn business income through a corporation and to defer the distribution of profits in a manner that would result in a personal income tax liability. So long as this situation persists, taxpayers will seek to defer the distribution of corporate income to shareholders regardless of what regime for taxing reinvested corporate profits is enacted.

Realistically, if acceptance of the current state of affairs is not tolerable for the Department of Finance or to the current Parliament, there are two means of addressing this problem: (i) abandon the quest for competitiveness and raise corporate income tax rates to match top personal income tax rates; or (ii) abandon counter-productive attempts to extract ever increasing tax revenues from high-earners and instead reduce personal income tax rates. The result in either case would be to narrow the gap between corporate income tax rates and personal income tax rates applicable to business income to something that is acceptable to the Department of Finance and the current Parliament. However, only the latter approach would avoid the potential damage to the Canadian economy that could be caused by internationally uncompetitive tax rates. The choice is not a difficult one.

#### IV. CONCLUDING COMMENTS

Ultimately, we believe that this entire initiative by the Department of Finance is an attempt to mitigate the symptoms of larger Canadian tax policy problems in a piecemeal fashion that avoids confronting those larger problems. A more intellectually satisfying and sustainable approach may be to undertake a broader review of the Canadian income tax environment, including a re-examination of the tax unit, the integration model, and the taxation of corporations and shareholders more generally. The Act can then be amended in a comprehensive fashion so as to align the legislation in its entirety with the answers to these fundamental questions.

We would be pleased to discuss the preceding comments with you, or to otherwise participate in the consultative process. Please do not hesitate to contact the writers should you have any questions or concerns.

Yours very truly,

**FELESKY FLYNN LLP**

A handwritten signature in blue ink, appearing to read 'Anthony V. Strawson', is written over the typed name and extends across the typed name and 'H. Michael Dolson'.

PER: Anthony V. Strawson  
H. Michael Dolson

AVS:md