The Joint Committee on Taxation of
The Canadian Bar Association
and
Chartered Professional Accountants of Canada

Chartered Professional Accountants of Canada, 277 Wellington St. W., Toronto Ontario, M5V3H2
The Canadian Bar Association, 500-865 Carling Avenue Ottawa, Ontario K1S 5S8

August 25, 2016

Brian Ernewein
General Director, Tax Policy Branch
Finance Canada
90 Elgin Street
Ottawa, ON K1A 0G5

Dear Mr. Ernewein:

Subject: Federal Budget 2016 - Proposed Amendments to Small Business Deduction Entitlement and Transfer of Life Insurance Policies

We are enclosing a submission which considers the proposed changes to the Income Tax Act (the "Act") as they relate to the small business deduction and the transfer of certain life insurance policies.

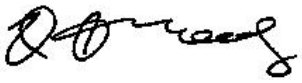
The initial version of these changes was proposed in the budget announced by the Honourable Bill Morneau, Minister of Finance on March 22, 2016, and a revised version was included in the *Legislative Proposals Relating to Income Tax, Sales Tax and Excise Duties and Explanatory Notes Relating to the Income Tax Act, Excise Tax Act, Excise Act, 2001 and Related Legislation* released by the Department of Finance on July 29, 2016 (the "Legislative Proposals"). Overall, we appreciate the concerns that the Department of Finance Canada has regarding the multiplication of the small business deduction and the perceived abuse over non-arm's length transfers of life insurance policies. While we agree with the overall framework of the proposed changes, our members have raised certain observations and suggestions for your consideration which are described in the attached submission.

We would like to thank you for your consideration of this matter. A number of members of the Joint Committee and others in the tax community have participated in the discussions concerning our submission and have contributed to its preparation, in particular:

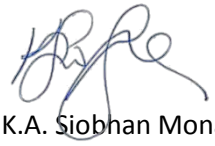
Kim G. C. Moody (Moodys Gartner Tax Law LLP)
K.A. Siobhan Monaghan (KPMG Law LLP)
Kenneth Keung (Moodys Gartner Tax Law LLP)
Hugh Neilson (Kingston Ross Pasnak LLP)
Bruce Ball (BDO Canada LLP)

We trust that you will find our comments helpful and would be pleased to discuss them further at your convenience.

Yours very truly,



Kim G. C. Moody
Chair, Taxation Committee
Chartered Professional Accountants of Canada



K.A. Siobhan Monaghan
Chair, Taxation Section
Canadian Bar Association

Cc: Gabe Hayos, Vice President, Taxation, CPA Canada

Federal Budget 2016 - Proposed Amendments to Small Business Deduction Entitlement and Transfer of Certain Life Insurance Policies
Joint Committee Comments
August 25, 2016

Proposed Amendments to Small Business Deduction Entitlement

We appreciate that the Government perceives a significant policy issue guiding these amendments, being the restriction of a single business to a single Small Business Deduction (SBD). We further commend the effort to permit business owners to allocate their SBD eligibility amongst corporations involved in their business operation(s). However, we question whether these objectives could be attained with reduced administration required of both the taxpayer and the CRA. To this end, we have the following suggestions:

(a) The proposed definition of specified corporate income (SCI) in subsection 125(7) will restrict access to the SBD on payments between many private corporations, including corporate groups which have no ability to utilize such payments to enhance access to the SBD. We recognize that the corporation paying for property or services can assign a portion of its business limit to the other corporation under proposed subsections 125(3.1) and (3.2), but these corporations are already allocating one business limit among them under subsection 125(3). We believe that simultaneous assignments and allocations of the same business limit will be confusing to taxpayers. As well, this creates unnecessary red tape for both the businesses preparing these assignments and the CRA to process them.

The simultaneous application of subsection 125(3) and proposed subsections (3.1) and (3.2) may also produce potential pitfalls for associated corporations as part of the assignment process. For example, consider the following situation: Corporation A and Corporation B are under common control, and during the year, Corporation A's only income was $150,000 derived from its provision of services to Corporation B. Expecting Corporation A's taxable income to be $150,000, Corporation A and Corporation B file an agreement under subsection 125(3) to assign 30% of the associated group's business limit to Corporation A so that, under subsection 125(3), Corporation A's business limit for the year is $150,000 and Corporation B's business limit for the year is $350,000. However, since the $150,000 income of Corporation A represented an amount of income described in subparagraph (a)(i) of the definition of SCI, Corporation B must assign $150,000 to Corporation A under proposed subsection 125(3.2) in order to allow the income to be treated as SCI in the hands of Corporation A. As a result, while Corporation A would be entitled to claim the SBD on its $150,000 of SCI, Corporation B's business limit would be reduced to $200,000, i.e. 70% of $500,000 less $150,000 (as required by the simultaneous application of subsections 125(3), (3.1) and (3.2)). We recognize that this result could have been avoided if Corporation A and Corporation B had allocated 100% of the $500,000 business limit to Corporation B under subsection 125(3) and only effect the $150,000 assignment under subsection 125(3.2). However, we feel it is unfortunate that the legislative framework permits such a mistake to occur, and it is a foreseeable mistake for a taxpayer to make, particularly if the associated group is involved in complex transactions and/or consists of corporations with un-aligned year-ends.

Therefore we recommend that payments between corporations which are associated for the purposes of section 125 be removed from the definition of SCI. As corporations which are associated for purposes of section 125 are already limited to a single SBD to be allocated among

them, removing such payments from the SCI definition will reduce the assignments required under these new provisions, prevent confusion and inadvertent mistakes, without permitting enhanced access to the SBD.

(b) Proposed subsection 125(3.1) reduces a corporation's business limit under subsections 125(2), (3) and (4) by an amount equal to the amount that is the subject of an assignment made by it under proposed subsection 125(3.2). However, it appears to us that there is no explicit provision in the proposed legislation that would add the assigned amount under proposed subsection 125(3.2) to the assignee's business limit. To illustrate, consider the following situation: Corporation A and Corpoation B are under common control, and during the year, Corporation A's only income was $150,000 derived from its provision of services to Corporation B. Corporation A and Corporation B filed an agreement under subsection 125(3) to assign 100% of the associated group's business limit to Corporation B so that, under subsection 125(3), Corporation A's business limit for the year is $0 and Corporation B's business limit for the year is $500,000. At the same time, Corporation A and Corporation B also filed prescribed forms for the year to effect a business limit assignment of $150,000 from Corporation B to Corporation A under proposed subsection 125(3.2).

Accordingly, Corporation B's business limit, originally determined to be $500,000 under subsection 125(3), would be reduced to $350,000 under proposed subsection 125(3.1). On the other hand, it is unclear to us how the proposed legislation would add the same amount to Corporation A's business limit for purpose of paragraph 125(1)(c). Without such an addition, Corporation A would not be entitled to claim any SBD under subsection 125(1) because its business limit would remain nil, despite the assignment under subsection 125(3.2). We appreciate that a contextual or purposive interpretation of subsection 125(1) and proposed subsections 125(3.1) and (3.2) would likely find that an assignment under proposed 125(3.2) increases a corporation's business limit by the same. However, we believe that there should be an explicit provision to effect this addition to an assignee's corporation business limit, while maintaining the overall legislative purpose of preventing SBD mulitiplication.

Similar inequitable results could also occur between corporations that are not associated.

With this in mind, we recommend that proposed subsection 125(3.1) be revised to the following:

> If a corporation is described as the first corporation or the second corporation as referred to in subsection 125(3.2) for a taxation year, the business limit for the year of the corporation shall be determined by the formula
>
> A + B – C – D
>
> where
>
> A is the business limit for the year of the corporation under subsection (2), (3) or (4), and
>
> B the total of all amounts each of which is the portion, if any, of the business limit of a person that the person assigns to the corporation for the taxation year under subsection 125(3.2), and
>
> C the total of all amounts each of which is the portion, if any, of the business limit of the taxation year that the corporation assigns to another corporation under subsection 125(3.2), and

D is the amount, if any, by which
(i) A + B – C
exceeds
(ii) $500,000.

(c) The inclusion of paragraph (b) in the definition of SCI ("an amount that the Minister determines to be reasonable in the circumstances") creates significant uncertainty. It also seems likely disputes regarding this provision will require taxpayers and the Crown to engage in parallel litigation, as the exercise of CRA discretion is subject to judicial review by the Federal Court, while the other aspects of these provisions fall under the jurisdiction of the Tax Court. While we are uncertain what further mischief paragraph (b) is intended to guard against, it seems to have the potential to add significant uncertainty and administrative costs. Thus, we would first recommend consideration be given to the removal of this paragraph. However, if there is a perceived need for CRA to be able to address unanticipated abuses of this provision, we suggest some limits and guidance are appropriate. We note that the Technical Notes released by your Department on July 29, 2016 do not provide examples of the types of circumstances in which this proposed provision might apply. We recommend adding additional detail or examples regarding the factors to be considered by the Minister in making this determination, and articulating the purpose of this provision in detail.

(d) Proposed paragraph 125(3.2)(a) restricts the business limit assignment where the second corporation has an amount of income referred to in subparagraph (a)(i) of the definition of SCI from the provision of services or property directly to the first corporation. In effect, this "directly" requirement carves out the income earned "indirectly" as referenced in paragraph (a)(i) of the definition of SCI. We note that the word "directly" in paragraph 125(3.2)(a) was added in the Legislative Proposals. We are unclear what the distinction is between direct and indirect income. With the above in mind, we would again recommend adding details and examples regarding direct vs. indirect income and the factors to be considered by the Minister in making this determination, as well as articulating the purpose of this provision in detail in the Technical Notes to the provision.

(e) Proposed subsections 125(3.2) and 125(8) will permit assignments to be made to transfer access to the SBD between corporations receiving SCI or Specified Partnership Income (SPI). These assignments require prescribed forms to be filed by each of the assigning corporation and the recipient corporation. It is unclear whether the intention is for both corporations to file the prescribed forms, separate and apart from their (likely) electronically filed returns. We urge that any requirement to file forms outside of the electronic filing of the tax return itself be minimized, if it cannot be eliminated entirely.

We also note that the coming-into-force provisions applicable for the assignments under subsections 125(3.2) and subsection 125(8) permits an assignment from a person's taxation year that begins before March 22,2016 and ends after March 21, 2016. This may cause, in certain cases, administrative challenges. For example, if the person wishing to assign the small business limit has a taxation year that ends March 31, 2016, such assignment would require a prescribed form to be filed by the tax return filing due date for the year of that person (as well as the assignee). For the assignor corporation, that return would be due September 30, 2016. Given the state of the proposals, we recommend that the coming-into-force provisions applicable to subsections 125(3.2) and (8) permit the prescribed form in respect of a person's taxation year that ends before the provisions receive Royal Assent to be filed no later than 6 months following Royal Assent.

(f) Where a corporation is providing property or services to a partnership, the proposed definition of "designated member" in subsection 125(7) contains an exclusion from its application where

all or substantially all of the property or services of the corporation are provided to arm's length persons or partnerships other than the partnership in question. Under that definition, it would appear that a corporation will be a designated member if it meets one of two sets of conditions contained in subparagraph (b)(i) or (b)(ii) of the definition. Subparagraph (i) deals with a situation where one of the shareholders of the corporation is a partner while subparagraph (ii) deals with situations where the corporation does not deal at arm's length with the partner. The "all or substantially all" exclusion does not apply to subparagraph (i) while it does apply to subparagraph (ii). This difference in treatment, while likely intentional, appears to be unnecessary and unfair. Without such an exclusion, even a nominal investment in a service recipient partnership by the shareholder of the service provider corporation could cause the service income to be ineligible for the SBD. This stringent approach could discourage legitimate commercial investments and transactions. We believe that the "all or substantially all" exception should apply to both subparagraphs (i) and (ii).

(g) The Legislative Proposals added paragraph (c) to the description of A in the definition of SPI in subsection 125(7). This addition causes the SPI to be nil where the corporation is a member or designated member of a partnership that provides services or property to either a non-arm's length private corporation or a non-arm's length partnership and it is not the case that the provider partnership meets the "all or substantially all" arm's length income test. The addition of this paragraph, in our view results in a provision that is too broad and can catch situations that are likely not intended to be caught. For example, consider the following situation:

- A Co is a partner in a Partnership X;
- A Co also owns 10% of B Co, another private corporation;
- Partnership X provides services to B Co and arm's length customers and, during the current year, its income from the services provided to B Co constituted 15% of Partnership X's total income.

Since Partnership X provided services to B Co, which is a private corporation in which A Co holds an interest (albeit a small one) and it is arguably not the case that "all or substantially all"[1] of Partnership X's income is from the provision of services or property to arm's length persons, paragraph (c) would cause A Co's SPI to be nil. Consequently, A Co is not entitled to claim the SBD on any of its income allocation from Partnership X for the year even though only a portion of the allocation derives from services to B Co. This would seem to be an inappropriate result.

Our recommendation is to revise (c) to limit the SPI to the arm's length income of the partnership.

(h) Clause 125(1)(a)(i)(C) will restrict deemed active business income under subsection 129(6) from being eligible for the SBD if that income is earned from an associated corporation that is not a Canadian-controlled private corporation (CCPC) or is a CCPC that has made an election under subsection 256(2). However, it appears to us that such deemed active business income should, in almost all cases, also be an amount described in subparagraph (a)(i) of the definition of SCI such that the same restriction applies under clause 125(1)(a)(i)(A) already. The exceptions to this appear to be very limited and may include:

i. corporations associated with each other because one has *de facto* control over the other, but the first corporation (or any of its shareholder(s) or any non-arm's length persons) does not otherwise hold a direct or indirect interest in the second corporation, thereby falling outside of subparagraph (a)(i), or
ii. corporations are associated due to a person being deemed to own shares of a corporation under subsection 256(1.4) where that person otherwise deals at arm's length with the corporation, thereby falling outside of subparagraph (a)(i).

[1] CRA typically takes the position "all or substantially all" means 90% or more.

Therefore, we believe the addition of clause (C) to be redundant in most cases and suggest that introducing such complexity in order to catch these very narrow circumstances does not appear to justify the benefits. Accordingly, we recommend that clause (C) be removed from the proposed legislation.

(i) We note significant inflexibility in the formula contained in the proposed definition of specified partnership business limit ("SPBL") in subsection 125(7). Specifically, element 'K' restricts the calculation to a partner's share of the income of the partnership from an active business carried on in Canada. This restrictive approach may lead to a number of problems that could arise even in common partnership structures:

1. If a partnership carries on a specified investment business that requires services from a corporation that is a "designated member" of the partnership, the active business income derived by the designated member by providing such services would not be eligible for the SBD because the partner's SPBL would be nil and thus no SPBL may be assigned to the designated member. We see no mischief in allowing SPBL to be assigned in respect of the designated member's services.

2. If a partnership carries on an active business that requires services from a corporation that is a designated member and the net income of the partnership is nil, the same result as described above applies with respect to the designated member's income from providing such services. Again, we fail to see the mischief in permitting an SPBL to be assigned.

3. In certain cases, members of partnerships receive their otherwise proportionate share of partnership income by a combination of providing services to the partnership and receiving a reduced allocation of partnership income. Sometimes, the services are provided through a related non-partner corporation which would constitute a designated member of the partnership. Given the inflexibility of element 'K', the computation of a partner's SPBL is limited to the reduced partnership income allocation to that partner which in turn limits the amount of SPBL that may be assigned to that designated member. Again, we see no mischief in enabling the partnership members flexibility in determining the manner of their remuneration as long as the principle that a single business is permitted access to only one SBD is adhered to.

Our recommendation is to revise the definition of SPBL in subsection 125(7). Specifically, element 'K' should read as follows:

K is the total of:

i) the total of all amounts each of which is the person's share of the income (determined in accordance with subdivision j of Division B) of a partnership of which the person was a member for a fiscal period ending in the year from an active business carried on in Canada; and

ii) the total of all amounts each of which is described in subparagraph (ii) of the description of G in the definition of "specified partnership income" in this subsection that was paid or payable by the partnership in the fiscal period ending in the year to a designated member of the partnership in which the person holds a direct or indirect interest at the end of that fiscal period multiplied by the proportion that

A) the fair market value of the shares of the capital stock of the designated member owned at the end of that fiscal period by the person

is of

B) the fair market value of all the issued shares of the capital stock of the designated member outstanding at the end of that fiscal period.

In addition, element 'L' would require the following corresponding adjustment:

L is the total of:

i) the total of all amounts each of which is the income of the partnership for a fiscal period referred to in paragraph (a) of the description of A in the definition "specified partnership income" in this subsection from an active business carried on in Canada; and

ii) the total of all amounts each of which is an amount described in subparagraph (ii) of the description of G in the definition of "specified partnership income" in this subsection that was paid or payable by the partnership in the fiscal period ending in the year to all designated members of the partnership.

We acknowledge that our recommendation adds a significant administrative burden to the partnership and partners in order to accurately calculate element K. However, if the formulaic approach as proposed in the Legislative Proposals is to be implemented, then our recommendation is necessary.

Another alternative we wish to put forth is to completely discard the formulaic approach for determining SPBL. Rather than fixing the SPBL of a partner to a proportionate share of partnership income from an active business carried on in Canada, we suggest that a better approach may be to revise the definition of SPBL to be an amount agreed-upon by the partners. The definition will require that each year's partnership return specify each partner's share of a single business limit pertaining to the partnership (similar to the sharing of the business limit amongst associated corporations under subsection 125(3)). Then, pursuant to currently proposed subsection 125(8), each partner may choose to assign a portion or all of its SPBL to designated member corporations. This will still achieve the objective of preventing the multiplication of the SBD but will avoid the issues we have noted above with the current proposed definition of SPBL. In fact, this allocation scheme is consistent with how a business limit is assigned under subsection 125(3.2) for the purpose of determining SCI. Under subsection 125(3.2), a business limit is also assigned by the service/property recipient corporation to the service/property providing corporation on a flexible basis, with no requirement that the assignment be consistent with the proportion of service/property provided by each provider.

Proposed Amendments to Transfer of Certain Life Insurance Policies

We are in overall agreement with the proposed changes to the taxation of life insurance policies. However, for transfers of life insurance policies that were undertaken on a non-arm's length basis prior to March 22, 2016, the proposed legislation has a retroactive effect which is unfair to taxpayers who relied on the existing legislation to plan their affairs. Generally, the proposed rules will cause a reduction in the capital dividend account ("CDA") of a corporation to the extent the fair market value of the consideration received on a pre-March 22, 2016 non-arm's length transfer of a life insurance policy exceeds the greater of the cash surrender value ("CSV") of the policy and the adjusted cost basis ("ACB")

to the policyholder of the interest immediately before the disposition. Similar suppression rules apply to the adjusted cost base of partnership interests and paid-up capital of issued shares. We believe that the proposed amendments should only apply to non-arm's length transfers that take effect on or after March 21, 2016 and not affect tax attributes arising on to prior legitimate transactions.

We are familiar with the Conference for Advance Life Underwriting's ("CALU") submission on this matter. Like CALU, the Joint Committee recognizes that there may be a secondary tax benefit that may arise from the fact that the transferee corporation paid consideration for the policy that is not reflected in the ACB of the policy to the transferee corporation. If our recommendation above is not accepted, we support CALU's recommendation that rather than directly grinding the CDA by the excess of the consideration received by the transferor over the greater of the CSV or ACB of the policy, that the excess be added to the ACB of the policy at the time of death of the insured. In this way, the full extent of the net cost of pure insurance can be applied in computing the ACB of the policy which in turn would affect the computation of the CDA addition arising from the receipt by the corporation of the life insurance proceeds.