The Joint Committee on Taxation of
The Canadian Bar Association
and
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October 2, 2017

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Sent by email to fin.consultation.fin@canada.ca

Re: Tax Planning Using Private Corporations – Tax on Split Income and Limitation of Lifetime Capital Gains Deduction Proposals

We enclose a submission that considers the proposed changes to the *Income Tax Act* (Canada) (the "**Act**") arising from the legislative proposals released on July 18, 2017 with respect to the tax on split income and the limitation of the lifetime capital gains deduction.

This submission was prepared by a subcommittee of the Joint Committee on Taxation of the Canadian Bar Association and Chartered Professional Accountants of Canada ("**Joint Committee**"). This submission is one of three submissions prepared by Joint Committee subcommittees; other submissions address the legislative proposals regarding conversion of income to capital gains and the proposals regarding the tax treatment of passive income earned by private corporations.

With our focus on technical aspects of tax legislation, the Joint Committee generally does not address concerns over tax policy or changes thereto. This submission is no exception.

However, we wish to express two more general points with respect to the July 18 proposals generally (and these points relate not only to the income sprinkling proposals, but also to the other proposals released on July 18):

- In view of the broad nature of the proposals, and the fact that they could affect a wide spectrum of taxpayers, including many small businesses, we respectfully suggest that the 75-day period for comments, ending on October 2, 2017, was too brief a consultation period, and, as noted herein and in our other submissions, we recommend that a broader review be undertaken by an Advisory Panel or similar expert body.

- In our respectful view, it would be preferable if future communications regarding the proposed amendments could clarify that the proposed changes include many policy changes that cannot reasonably be characterized as the closing of "loopholes" in the legislation.

We are generally concerned that, overall, the proposals would add more complexity and uncertainty to provisions that are intended to apply to a large number of taxpayers, many of whom are unsophisticated, and unable to readily access tax advice. There is a real concern that taxpayers and their advisors may have difficulty complying, based on the nature of the issues we describe in the submission. As noted, for example, the proposals are based on the notion of what is "reasonable" compensation for family members. This determination is inherently subjective, giving rise to significant uncertainty for both taxpayers and Government. We suggest the analysis is broader than that needed to determine whether an expense such as salary is reasonable, as factors such as the return on invested capital, and overall economic contribution must be taken into account. We are concerned that the reasonableness test as proposed could give rise to a significant number of disputes, thereby imposing further costs on taxpayers and the Government, and further stressing an already backlogged Appeals Division.

Small business owners, their advisers and Canada Revenue Agency auditors are already challenged to deal with other recent and highly complex changes including the changes to testamentary trusts, subsection 55(2), and the small business deduction. The July 18 proposals would magnify these challenges, raising concerns about taxpayers' ability to comply with the self-assessment system.

A number of members of the Joint Committee and others in the tax community participated in the discussions concerning this submission and contributed to its preparation, in particular:

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- Hugh Neilson (Kingston Ross Pasnak LLP, Video Tax News)

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	Jeffrey Trossman
Chair, Taxation Committee	Chair, Taxation Section
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c.c.: Paul Rochon, Deputy Minister, Department of Finance Canada
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<u>Joint Committee Submission on the "Tax on Split Income and the Limitation of the Lifetime Capital Gains Deduction" Proposals described in *Tax Planning Using Private Corporations* dated July 18, 2017 (the "Consultation Paper")</u>

Table of Contents

Executive Summary 4
A. Complexity and Subjectivity 5
B. Inappropriate Application of Top Marginal Rates 19
C. Technical Issues 20
D. Legislative Alternatives 44
Appendix A
Illustrative Examples of Proposed TOSI Regime 47
Application of TOSI Provisions – ALBERTA 49
Application of TOSI Provisions – ONTARIO 56
Appendix B
Summary for matrimonial property separation for each Province and Territory 63

Executive Summary

The principal conclusions and observations that may be derived from our submission can be summarized as follows:

1. There are important non-tax reasons for carrying on business activities through a corporation. The corporate form limits the business owner's liability, thereby encouraging risk-taking. Corporations facilitate the raising of capital.
2. The premise of the Consultation Paper appears to be that employment income and business income should be placed on a similar footing and taxed on a similar basis. The premise also appears to be that the amount of income that a business owner should be entitled to receive (whether as a dividend or a capital gain) that is subject to marginal rates of tax is to be the amount which an employee would receive from employment or investment income.
3. We believe that the July 18, 2017 proposals with respect to the tax on split income ("**TOSI**") and the limitation of the lifetime capital gains deduction ("**LCGE**"), as they are currently drafted, are so complex and subjective that it will be virtually impossible for taxpayers and the Canada Revenue Agency (the "**CRA**") to determine with certainty if the rules apply, and if so, the extent to which they apply.
4. The Proposals link the recognition of income or realization of capital gains to the contribution of the recipient to the generation of that income or gain. The Proposals define contributions in terms of the person's function, capital invested and risks assumed with special tests depending on the age of the recipient. The analysis is subject to an overriding test of reasonableness after taking into account total amounts paid to the person in the year or prior years. Finally, the test takes into consideration what an arm's length person would have recognized or realized in comparable circumstances. The analysis is similar to that which is required in the international transfer pricing context. In the case of a private corporation, however, the tests will be considered by taxpayers and advisors who (i) in many cases will not have a degree of sophistication or a budget for advisory fees comparable to those of their counterparts in the international context; and (ii) have no available and appropriate arm's length comparables to consider in the context of deciding whether they meet the reasonableness test.
5. The application of the proposed TOSI rules, in practice will be very difficult, and we are concerned the proposed regime will essentially be unworkable. We believe that a large segment of private business owners in Canada will not be able to determine their appropriate tax obligation with certainty, and their annual costs to comply with their obligations under the Act, including the filing of tax returns and the associated documentation in support of the TOSI analysis will increase. Because the tests are complex and subjective, there is a concern that the CRA will be inclined to reassess in a wide spectrum of fact patterns on the theory that a Court might support their position, even where there is uncertainty. Taxpayers with limited resources will then be left with the choice of pursuing protracted and expensive dispute resolution processes or simply over-paying tax. Such a system runs the risk of being viewed as coercive, potentially causing taxpayers' faith in the fairness of the system to be eroded.
6. We believe that the challenges faced by taxpayers in seeking to apply the rules will also be faced by the CRA in administering the rules. Thus, the enactment of the Proposals will lead to additional burdens on the CRA, which will inevitably expend considerable resources in seeking to apply an unworkable test and to assess in a manner that reasonably insulates the CRA from criticism by the Auditor-General.

7. In considering whether TOSI will apply to a particular situation, the contribution and amounts paid to a specified individual will be measured against contributions made and income received in years prior to July 18, 2017 – for multi-generational businesses that could mean decades. The information necessary to complete the analysis may no longer exist as there would have been no requirement to document matters such as contribution. The books and records for a particular year may have been destroyed as permitted by the Income Tax Act (the "**Act**").
8. If enacted, the Proposals will have implications with respect to the amount of tax paid on income and dividends, the availability of the LCGE and, depending on the relationship of the purchaser to a seller, whether a gain will be subject to tax as a capital gain or an ordinary dividend. The transfer of a business to the next generation, whether during the business owner's lifetime or on death, will be more difficult and more costly (both in terms of taxes paid and compliance costs). As the tax consequences of a sale to an arm's length party are more certain than a sale to a non-arm's length person, we are concerned that the Proposals will incentivize the owners of family businesses to sell to third parties, such as public companies and private equity funds, rather than keeping the business in the family.
9. We are concerned that the TOSI proposals will have an adverse effect on the ability of start-up and emerging companies to obtain financing from family members. This could frustrate other initiatives of the Government which seek to support the growth of new and emerging businesses, particularly in the "knowledge economy".
10. Our submission identifies a number of technical issues arising out of the Proposals, including the relevant point in time for determining various components of the contribution test, and the manner of allocating the contribution of a deceased person to a specified individual (particularly in the case of 18-24 year olds).
11. The proposed TOSI rules will result in top marginal tax rates to family members who would not have been subject to these rates in the absence of income sprinkling. We provide some detailed numerical examples in Appendix A.
12. Throughout the submission, we have suggested options for addressing some of the issues that we have identified. In the last section of our submission, we propose alternatives including expanding the so-called "Kiddie Tax" to age 24, while ensuring that young entrepreneurs and those working full time are not penalized; expanding the existing attribution rules; restricting the availability of the LCGE to a family unit (defined to include a spouse or common law partner and dependent children) who hold shares in an associated group of companies; and a valuation day alternative for the LCGE.

A. Complexity and Subjectivity

As currently enacted, the Tax on Split Income ("TOSI") contains bright line tests[1] with the result that the application of TOSI to a particular dividend or certain partnership or trust income can generally be determined with certainty. In contrast, the Draft Legislation contains rules that are complex and subjective, the consequence being that the application of TOSI to interest, dividends, partnership income, trust income, or capital gains will not be certain. The businesses that will be required to comply with TOSI are generally owned by families. The proposed TOSI rules do not apply where shareholders are otherwise unrelated. Family–owned businesses are thus put to a higher compliance burden and risk of audit by the CRA than their competitors whose shareholders are not related.

1) Uncertainty associated with the "reasonableness" tests in subparagraph (b)(iii) of the proposed definition of "split portion" (referred to as "subparagraph (b)(iii)" below)

[1] With the exception of Subsection 120.4(4) which applies to a sale to a non-arm's length purchaser.

The test contained in subparagraph (b)(iii) is extremely subjective, complicated, and difficult to interpret and apply to a particular set of facts and circumstances. We are concerned that the reasonableness test may result in substantial additional compliance costs to many owners of private businesses. Such businesses may need to (i) create additional documents, such as detailed time sheets and diaries, to track each family member's functions, contributions, and risks assumed, (ii) evaluate the effect of a change in function, contribution and risk assumed over time, (iii) retain books, records and these additional documents in perpetuity in order to support reasonableness of any income or gain in the future; and (iv) analyze records since inception for each future "split income" earned.

Even if such efforts to document filing positions are made by taxpayers,[2] residual uncertainty as to the results determined will remain because the reasonableness test is inherently subjective. We are concerned that the CRA, in applying the subjective reasonableness test, may conclude that a particular payment is unreasonable. Taxpayers will then be subject to the usual reverse onus that applies in tax cases, and it may be extremely challenging, stressful and costly to prove reasonableness. The reassessed taxpayer could well either (i) accept the reassessment because the costs of disputing it will be disproportionate, or (ii) object and appeal. A large number of objections and appeals could further strain the already challenged resources at CRA Audit, CRA Appeals and the Tax Court of Canada.

Below are highlights of some of the reasons why we believe the reasonableness test in subparagraph (b)(iii) may prove to be vague and uncertain in its application. In many of our discussions, we referred to corporations and their shareholders to illustrate our concerns, but those concerns generally apply equally to certain income from partnerships and trusts.

a. The only possible bright line is where a shareholder who has received a dividend or a capital gain has had no involvement in the business whatsoever. Even in these situations, it may be debatable whether a spouse or, in some circumstances, a child could be seen as having made indirect contributions to the family business.

b. The criteria of functions performed and risks assumed (which are concepts that appear to have been borrowed from the very different context of cross-border international transfer pricing) are subjective and difficult to determine with certainty, yet the test in subparagraph (b)(iii) forces taxpayers to weigh all these very different factors to arrive at a single monetary value (or at least an amount that is no greater than the amount that is reasonable). It is not difficult to foresee how, even in the simplest business, dealing with subparagraph (b)(iii) will be a challenge. For example, a specified individual may work full time in a business, but the functions performed may not be as valuable as the functions performed on a part-time basis by another specified individual, or a specified individual has founded and solely built up the business but has retired from the day-to-day operations for the past decade. In scenarios as simple and common as these, it is impossible for the taxpayer to conclude with certainty what is a reasonable income or capital gain amount for each of these specified individuals.

   The test will require an ongoing analysis of the individual's cumulative contribution from the start of the person's involvement to the time of the receipt of an amount. The outcome produced by the test would evolve over time depending on the person's

[2] Such documentation standards to support filing positions regarding the reasonable test in subparagraph (b)(iii) will likely be analogous to the transfer pricing requirements under subsection 247(3) of the Act.

contribution to that point (for example, due to maternity leave, disability, illness, increased responsibility in the business or transitioning a role to the next generation), which further adds to the uncertainty of the tax treatment of each and every item of income or capital gain earned by a specified individual from private businesses.

c. Pursuant to subparagraph (c)(ii) of the proposed definition of "split portion", the reasonableness test contained in subparagraph (b)(iii) also applies to capital gains realized by a specified individual. That subparagraph causes an amount of capital gain to be a split portion to the extent that it would be split income if the same amount were received as a dividend, interest, or income from a partnership or trust, as the case may be. In other words, the amount of the capital gain is subject to the same reasonableness test as if the amount were received as a dividend, interest, or income from a partnership or trust, depending on the type of property disposed of.

   Dividends and income from partnerships or trusts generally represent cash flow or profits (after-tax, for dividend distributions) of a business in a particular year. Interest represents the return on the principal amount of debt. On the other hand, a capital gain reflects the growth, accumulation and monetization of an underlying business, the assets comprising the business and historical profitability or EBITDA. Capital gains may result from a host of factors, including market forces, competitive issues and sheer luck. This raises challenges in determining how much of a capital gain should properly be said to have been "earned" by a particular shareholder.

   Realized capital gains are often much larger in quantum than a regular or recurring dividend, interest, or income from a partnership or trust, thereby increasing the risk associated with an incorrect reasonableness determination. A number of different tax implications flow from the reasonableness determination of a capital gain of a specified individual: (i) some part of the capital gain may be subject to TOSI but another portion will not; (ii) if the disposition is non-arm's length, some portion of the gain will be subject to tax as a dividend under subsection 120.4(4) or (5) but another portion will be taxed as a capital gain; and (iii) the LCGE will be available in respect of only a portion of the capital gain.

d. As noted above, the principles proposed to be applied are similar to those applicable to cross-border transfer pricing[3]. However, in the context of small businesses, no comparable data are available in respect of what constitutes arm's length non-salary income or capital gains from a private business, nor can we see how such data are likely to become available. Salaries of an employee are relatively steady and guaranteed as compared to the earnings of a business owner. A family business creates both employment opportunities and investment opportunities, whereas a person drawing only a salary does not typically have an investment opportunity. If a business fails, in addition to the loss of employment, the business owner loses those assets and assets used to support any borrowing or lines of credit. An employee, on the other hand, would lose his or her job. Therefore, in many circumstances, salaries of arm's length employees may not be the appropriate benchmark for determining what is a reasonable income or capital gains amount for purposes of subparagraph (b)(iii).

[3] The transfer pricing requirements are set out in section 247 of the Act.

Public company dividend returns are also not a relevant comparable for many reasons. Size is one obvious difference, as the large majority of private businesses are smaller than any publicly-listed companies in their sector. The arm's length return on equity of a small growing company can be very different than that of a mature one. Perhaps the only type of publicly-listed securities that might be considered comparable to most private businesses are micro-cap or "penny" stocks, but these types of stocks typically do not pay dividends and often either give rise to a significant gain for the investor or become worthless. It will be very difficult to use these securities to benchmark the reasonable returns for most private businesses. Furthermore, the return on public company shares is often influenced by outside factors that may not impact private businesses as much, such as stock market trends, and currency fluctuations. Also, dividend yields for public companies are computed based on the market value of the stock whereas a private business owner's stock is almost always accounted for on an historical cost basis (which typically would be a relatively small or nominal amount). As such, dividend yields for publicly listed stocks cannot generally be used as a measure of reasonableness.

Without objective, widely available, comparable data, we are concerned that there will be inherent uncertainty as to whether an amount is caught by the reasonableness test in subparagraph (b)(iii).

e. A reasonable interpretation of the test described in subparagraph (b)(iii) would be that functions performed, assets contributed, and risks assumed are to be "allocated" to all those involved in the source business, analogous to an agreed-upon allocation of the small business limit in subsection 125(3) of the Act. For example, if Shareholder A performed 60% of the functions and Shareholder B performed 40%, then the function factor that is part of the TOSI determination needs to be allocated 60/40 to Shareholder A and B, respectively. The difficulty of determining this multiplies exponentially for large family businesses, as each participant needs to assess his or her own contributions relative to all other participants. Therefore, to comply with subparagraph (b)(iii) appropriately, parties will effectively need to reach a percentage allocation agreement in respect of each of the functions performed, assets contributed and risks assumed; yet this will likely not be feasible. Functions and risks are subjective and the reasonable value attached to these are in the eye of the beholder, so requiring an allocation will require difficult and time consuming negotiation, potentially leading to disputes.

f. In the case of business interests that are inherited, proposed clause 120.4(1.1)(e)(ii)(C) will require an understanding and analysis of the deceased's cumulative contribution prior to his or her death. In this case, to the extent of the portion of the relevant property of the deceased acquired by the individual, (i) the functions of the deceased are deemed to be functions of the individual, (ii) the assets contributed by the deceased are deemed to be assets contributed by the individual, and (iii) the risks assumed by the deceased are deemed to be risks assumed by the individual. Additionally, the amounts paid or payable by any person to the deceased in respect of the source business are deemed to have been paid to the individual.

   While at first blush this is a welcome proposal, this provision will in practice add further complexity and uncertainty to the analysis of whether a particular amount will be subject to TOSI. Consider, for example, the situation where a shareholder under the age of 24 acquires shares from her deceased grandparent. Subparagraph 120.4(1.1)(e)(iii) provides that no functions are to be considered unless she is engaged on a regular, continuous and substantial basis in the business, and yet, clause 120.4(1.1)(e)(ii)(C) deems her function to include a portion of her grandparent's historical function.

The uncertainty and subjectivity of the reasonableness tests in subparagraph (b)(iii) is greatly magnified when this clause is applicable because the knowledge and records pertaining to the deceased's functions, contributions, risk, and remuneration over the deceased's lifetime may be lost, or very difficult to obtain or determine and, needless to say, the deceased person is not able to provide any input or context.

g. It is not certain whether, in reviewing the four factors referred to in subparagraph (b)(iii), events occurring prior to the start of the relevant year should be considered. Within subparagraph (b)(iii), the only references to time are in clause (b)(iii)(A) "… *functions ... before the amounts were paid or became payable*", and in clause (b)(iii)(D) "… *all amounts that, before the end of the year, were paid or that became payable* …". Based on this alone, it would appear that the four factors in subparagraph (b)(iii) should include historical events prior to the start of the year. The assets contributed factor in clause (b)(iii)(B) suggests the same, since asset contribution is usually a cumulative concept in the Act (e.g. adjusted cost base and paid-up capital).

   On the other hand, subparagraph (b)(iii) is a reasonableness test that is applied to "*the particular amount*". "The particular amount" is a reference to "*a particular amount*" first mentioned in the preamble of the "split portion" definition which is specifically limited to an amount "*in respect of a taxation year*". Subparagraphs (b)(i) and (ii) of the definition continue to reference "*the particular amount*" in the context of the year in question. A possible contextual interpretation could conclude that because "*the particular amount*" refers to the amount in a year, the factors used to test reasonableness of "*the particular amount*" should only include events occurring during the year.

   In our view, this restrictive interpretation is not the correct (or intended) interpretation, but we recommend that the Explanatory Notes be expanded to clarify whether or not historical events should be considered in assessing the four factors in the subparagraph (b)(iii) reasonableness test. In the balance of this submission, we assume that all historical events should be considered in applying the test.

To improve certainty of application, we recommend that certain legislative presumptions be incorporated into the reasonableness test, and that the Explanatory Notes be expanded to include detailed examples. We would be pleased to engage with Finance to further discuss how to mitigate or reduce the uncertainty associated with the reasonableness test.

2) Who is responsible for determining the application of TOSI?

It is not clear from the draft legislation who is responsible for determining the amount that is subject to TOSI. Is it the specified individual taxpayer reporting the income, the connected individual or the payer who is responsible for issuing the T3 or T5 tax slips? The perspective of one or the other could be quite different. Many taxpayers, as well as the CRA, rely heavily on the accuracy of these reporting slips in reporting their income.

In a closely-held situation where the related business owners are spouse and minor children, it is likely that the active owner will be involved in tax compliance for the other owners, so that this allocation can be administered. However, this is unrealistic in the context of businesses with related owners over the age of majority. The lack of coordination may result in specified individuals over- or under-reporting TOSI.

3) Retroactive look-back requirements involved in the proposed TOSI and LCGE determination

The changes to TOSI will take effect on January 1, 2018; however, the person's contribution for purpose of applying the reasonableness test in subparagraph (b)(iii) of the proposed definition of "split portion" requires a look-back to periods going back to the time when the person first became an owner or loaned funds to the business. The records for those periods may no longer be available or may be difficult to obtain, since, prior to July 18, 2017, taxpayers would never have expected that they would be required to justify reasonableness of future income or capital gains with their then present-day contributions. In respect of a family farm partnership, family farm corporation or other farm assets, the look-back may encompass decades of history since such assets have been eligible for tax-deferred transfers between the generations since capital gains became taxable in 1972.

With respect to the factor in clause (b)(iii)(D) of the definition of split portion, it will be difficult to determine the total historical amounts that were paid or payable, directly or indirectly, to the specified individual in respect of a longstanding business. Moreover, the test does not address an individual's changing role in a business – including increased or reduced responsibility over time, retirement, maternity leaves, illness, periods of physical or mental disability. This will be even more complicated when dealing with contributions in respect of assets inherited on death.

The Draft Legislation takes into consideration dividends paid to a person prior to 2018 when the rules were not in effect. If a business had an unexpectedly successful year in, say 2010, and paid an extraordinary dividend, that dividend will need to be considered in the analysis of whether the amount received in 2018 is reasonable. If it is determined that the amount paid historically, including the dividend paid in 2010, exceeded what a business would have paid an arm's length individual of the same function / asset contribution / risk assumption profile over the entire holding period, a portion of the dividend paid in 2018 will potentially be subject to TOSI. It will be very difficult to make such determination with any degree of certainty.

We suggest that the legislation should expressly acknowledge the difficulty in establishing reasonableness in view of the fact that taxpayers could quite properly have assumed that they would not need to maintain records of contributions for past periods.

Similar issues apply in respect of the "fresh start" limitations with respect to the claiming of LCGE in proposed paragraphs 110.6(12)(c) and (e) of the Draft Legislation. To properly determine the reduction of the LCGE entitlement, a taxpayer must identify critical dates during the applicable holding period including when the individual turned 18 or received property on a tax-deferred basis under subsection 107(2) from a trust other than an eligible LCGE trust. It will often be difficult and impractical to obtain such historical information. Prior to July 18, 2017 taxpayers would not have known that this information was required.

Consider the following example. In 2001, Family Co was incorporated and Jane subscribed for 20% of the shares for $20. Jane was 16. Her parents, both active in the business, were the remaining 80% shareholders. The business was financed by an operating line of credit that was secured by the equity in the parents' home. The business struggled for a number of years. When Jane finished university in 2008, at the request of her parents, she started to work in the company, starting in the mailroom and over time progressed into a leadership position. In 2010, her mother passed away and her Family Co shares were held by a spousal trust for the benefit of Jane's father. In 2010, there were sufficient liquid assets; the equity on the house was no longer required as security for the business and was discharged. By 2012, Jane's father retired although he continued his position as a director. Jane was very busy in caring for her father and running the business and ultimately she was not able to address adequate steps to crystallize a capital gain in 2018. In 2019, Jane received an unexpected offer to buy the business from a US company wishing to expand into Canada and the business was sold for $750,000. The proceeds are allocated as follows:

- Father - $300,000
- Testamentary spousal trust - $300,000 (distributed to Father)
- Jane - $150,000

Based on the rules as currently drafted, it will be necessary to:

- determine what portion of Jane's capital gain accrued before Jane turned 18 in 2003 and is therefore ineligible for the LCGE;
- analyze Jane's contribution to the business (but taking into account historical remuneration) to determine what portion of her $150,000 gain was reasonable and what portion will be subject to TOSI and be ineligible for the LCGE;
- analyze her father's contribution to the business (but taking into account historical remuneration) to determine that the portion of his $300,000 gain was reasonable and if not, which portion would be subject to TOSI and be ineligible for the LCGE;
- with respect to the $300,000 of capital gain distributed by the testamentary trust to the father, (i) determine if the trust meets all of the conditions for an "eligible LCGE trust", (ii) determine whose contributions are to be considered in respect of the gains accruing on the shares held by the testamentary trust: the deceased mother, the trustees of the trust, and/or the beneficiary (i.e. father)? (iii) determine whether historical dividends to the trust, that are either taxed in the trust or taxed in the father's hands, impacts the reasonableness test for the father, (iv) determine what portion was reasonable, and if not, what portion will be subject to TOSI and be ineligible for the LCGE.

The challenge is compounded because the books and records for 2001, 2003, 2008 and 2010 are no longer available because they were destroyed as permitted by section 230 of the Act. The family also would not have known prior to the release of the Consultation Paper that they needed to retain these historical books and records in order to determine reasonableness.

In light of the various difficulties and uncertainty associated with the reasonableness test, we recommend that the legislation expressly acknowledge the fact that records will normally not be available to rebut the reverse onus that taxpayers face in tax cases. One possibility would be to include legislative provisions shifting the evidentiary burden to the Crown, at least with respect to the establishment of the reasonableness of pre-announcement date contributions.

4) Tracing uncertainty for multi-tiered and/or multi-business structures.

   Under paragraph (b) of the proposed definition of "split portion", a particular amount may be a split portion if the amount can reasonably be considered to be derived directly or indirectly from an operating entity in respect of its "source business", and the amount exceeds a reasonable amount that an operating entity dealing at arm's length with the specified individual would have paid having regard to the four factors as they relate to the source business. The application of this provision potentially results in uncertainty where multi-tiered or multi-business structures are involved. For example, a specified individual owns shares of Holdco, which owns, either directly or through corporate/partnership subsidiaries, a number of different businesses – each one a "source business" for purpose of the split portion definition. The specified individual could have contributed differently to different underlying source businesses. The proposed rules provide no clear guidance (besides "*reasonably be considered to be derived directly or indirectly*") on how to trace portions of dividends or capital gains to each particular underlying business in order to properly apply the reasonableness standard for each underlying source business.

   Often, in family business groups, different family member individuals who are shareholders will assume responsibility for different business units owned by the group. Accordingly, the above noted issue will be commonplace and very difficult to administer. We do not have a recommended solution for this issue, but please consider our proposed legislative alternatives later in the submission.

5) Use of "*does not deal at arm's length*" as the trigger for subsections 120.4(4) and (5)
   Proposed subsections 120.4(4) and (5) provide that on a disposition of a share to a non-arm's length person, the portion of the gain that is not an excluded amount will be subject to tax as an non-eligible dividend and not a capital gain (i.e. the 50% inclusion rate is no longer available). This is in addition to denying the shareholder access to the LCGE as a result of proposed paragraph 110.6(12)(d). The consequences of proposed subsections 120.4(4) or (5) are severe, and there can be inherent uncertainties in the application of the "arm's length" test. This will result in much uncertainty in its application as explained below.

   a) Subsection 251(1) defines when persons are not dealing at "arm's length", and that includes (a) persons related to each other, (b) most personal trusts and their beneficiaries, and (c) persons not dealing at arm's length with each other at a particular time as a factual matter. While the first two are bright-line tests, determining whether the purchaser is, at the time of sale, dealing with the seller at arm's length as a factual matter can be uncertain and controversial. The difficult issues are highlighted by the Federal Court of Appeal decision in *Turgeon*.[4] The matter becomes more complicated in the case of proposed subsection 120.4(5) in determining whether the capital gain distributed by a trust to the beneficiary (who is also a specified individual) is the result of the disposition of shares to a person with whom the beneficiary does not deal at arm's length. Unless the beneficiary is also the trustee who is making the decision to sell the shares, the beneficiary may not have access to the identity of the purchaser. On the other hand, the trustee may not be aware of a non-arm's length relationship between the purchaser and the beneficiaries.

[4] Poulin v Queen and Turgeon v Queen heard on common evidence, 2016 TCC 154.

b) When a shareholder of a private corporation dies and her or his shares pass to the estate, it is not clear whether this constitutes a disposition of shares to a person with whom the deceased does not deal at arm's length.

On the one hand, it is the CRA's longstanding view that a transfer of property from a deceased to the estate or to a trust created by the will does not take place at arm's length.[5] This view is supported by the Tax Court of Canada's decision in *May Estate v MNR* which found that the transfer of property from the late Karna May to her estate was between parties not dealing at arm's length.[6]

Having said that, at the time of the deemed disposition under paragraph 70(5)(a), the estate does not yet exist. Arguably, and notwithstanding the above authorities, it is not possible for the deceased and the estate to be not dealing at arm's length "*at a particular time*" on a factual basis, as is required by paragraph 251(1)(c). There are no deeming provisions in the Act that cause a deceased individual and her or his estate to not deal at arm's length. Further, no legislative provision deems the deceased to have disposed of property to the estate, nor the estate to have acquired the property from the deceased. Also, the Act does not deem any other party to these transactions.

If the transfer by a deceased individual to her or his estate indeed constitutes a non-arm's length transfer, proposed subsection 120.4(4) could apply on the death of a private corporation shareholder who is a specified individual. As will be discussed later in this submission, that could have negative tax implications to the estate.

c) Proposed subsections 120.4(4) or (5) apply on a disposition of shares "*to a person with whom the specified individual does not deal at arm's length*". This phrase does not specify that the transferee needs to be a different person than the specified individual. There are numerous instances in the Act where a person is deemed to have disposed of and to have reacquired property, such as pursuant to paragraphs 128.1(4)(b) and (c) upon an emigration. Although an individual is not deemed to be related to herself or himself for general purposes of the Act, an individual could potentially be factually not dealing at arm's length with herself or himself. This is consistent with the CRA's view in an old interpretation document: "*it is a question of fact whether, at a particular time, that person is dealing with themself [sic] at arm's length*"[7]. Without further clarification from Finance or from the CRA, the potential application of proposed subsection 120.4(4) or (5) will add significant uncertainty to any deemed dispositions and reacquisitions by an individual or a trust.

We recommend that subsection 120.4(4) make it clear that it will not apply to a transfer of shares by the deceased to her or his estate, and that subsections 120.4(4) and (5) will not apply to a deemed disposition and reacquisition by the same taxpayer (see subsection 48.1(1) for an example of a legislative exception for subsections 120.4(4) and (5) in respect of a deemed disposition and reacquisition). Having said that, our submission notes below that we believe there are good reasons why subsections 120.4(4) and (5) should be repealed altogether.

[5] CRA Income Tax Folio S1-F5-C1, Related Persons and Dealing at Arm's Length, paragraph 1.52.
[6] [1988] 1 C.T.C. 2303.
[7] CRA document no. 9604655, May 23, 1996.

6) Vagueness of "other financial assistance" in clause 120.4(1.1)(e)(ii)(B)

In applying the reasonableness test in subparagraph (b)(iii) of the proposed definition of "split portion", clause 120.4(1.1)(e)(ii)(B) of the Draft Legislation carves out of the contribution of assets: (i) assets derived, directly or indirectly, from an amount that is split income for any taxation year; (ii) assets acquired in circumstances where a related person provided a guarantee, covenant or agreement to ensure repayment by the individual or (iii) assets acquired in connection with a related person providing "*any other financial assistance*".

The category of "*any other financial assistance*" is unclear. For instance, if a child earns a reasonable salary from the family business (but would not have been employable elsewhere because of the local job market conditions), and the child uses the salary received to buy shares of the business, it will be difficult to determine whether those shares constitute shares acquired in connection with a related person providing "*any other financial assistance*" and thus should be carved out from the asset contribution factor.

This test will require the tracing and determination of which assets are acquired "*in connection with*" a related person's financial assistance and which are not. Such tracing and determination will be difficult to comply with given the vagueness of the test. For example, assume the parents pay for the schooling for their child, who as a result was able to save up his or her salary received from an arm's length employer in order to invest in a private business. It is not certain whether the amount of the child's contribution to the business needs to be reduced by the tuition paid by the parent when considering the subparagraph (b)(iii) reasonableness test. Another example would be where one spouse pays for household expenses, allowing the other to contribute assets to the family business. It could be construed that those contributions could be ignored since they are acquired in connection to the spouse providing financial assistance.

We recommend that clause 120.4(1.1)(e)(ii)(B) replace the concept of "*in connection with … other financial assistance*" with a more precise formulation that clarifies the connection between the funding and the investment in the corporation. We would be pleased to engage with Finance to further discuss how this portion of the test may be made less uncertain.

7) Tracking uncertainty relating to secondary income

Paragraph (g) of the proposed definition of "split income" deals with income or gains from, or from the disposition of, property earned or realized by an individual under the age of 24 that can reasonably be considered to be attributable, directly or indirectly, to an amount that is (i) split income of the individual, (ii) income that is subject to the attribution rules, and (iii) capital dividends received by the individual.

Tracking funds from one of these three sources to the property being acquired could be problematic. For example, a child can receive split income at the age of 10, while receiving other monetary gifts and earn a reasonable salary after that time. If the child makes an investment with her or his savings at age 22, it might be impossible to determine what portion of the investment is attributable, directly or indirectly, to the split income the child received at age 10. To properly comply with this aspect of the Draft Legislation, individuals under 24 will likely need to keep a separate bank account to separate any TOSI, income subject to attribution, or capital dividend from the rest of her or his money.

The tracking issue is further complicated when income previously subject to attribution becomes no longer attributable. For example, if an individual transfers $100,000 to a non-arm's length minor for the minor to purchase $100,000 of property that is outside of the definition of "split income" (e.g. publicly listed shares), income earned by the minor on that $100,000 of property is attributed to the transferor under subsection 74.1(2). If the minor reinvests that income, the second generation income will attract TOSI under paragraph (g) of the "split income" definition.

However, once the minor turns 18, attribution ceases, and second generation income after that time arising from the investment of income from the original $100,000 of property should no longer be caught by paragraph (g). Nonetheless, future income generated on income earned prior to age 18 (both on the reinvestment of the income on the $100,000 of property prior to age 18 and on the reinvestment of the secondary income earned prior to age 18), will continue to be caught by paragraph (g) until the individual turns 24.

Tracking funds and income to properly comply with paragraph (g) of the definition of "split income" will be an exceedingly complex bookkeeping burden for taxpayers under the age of 24, even for a small amount of second generation income. We recommend Finance consider a *de minimis* exception for paragraph (g).

8) Inheritance of a business and clause 120.4(1.1)(e)(ii)(C)

In the case of a business that is inherited an individual, proposed clause 120.4(1.1)(e)(ii)(C) deems a deceased person's cumulative performance of functions, contribution of assets, and assumption of risks prior to his or her death to have been performed/contributed/assumed by the individual. The amounts paid or payable by any person to the deceased in respect of the source business are also deemed to have been paid to the individual. This appears to be a relieving provision so that the inheriting individual may take on the deceased's characteristics in assessing the reasonableness test in subparagraph (b)(iii) of the proposed definition of "split portion". However, the application of clause 120.4(1.1)(e)(ii)(C) in practice may be difficult as illustrated below:

a) Where the deceased was the founder and was paid substantial dividends, this may result in amounts paid to the inheriting individual being a split portion due to those substantial dividends having been previously paid (and therefore deemed to have been paid to the individual pursuant to clause 120.4(1.1)(e)(ii)(C)). It will be difficult to make an accurate determination of the extent to which historical payments should impact the reasonableness of income earned by the individual going forward. It may also be necessary to determine whether the deceased was subject to TOSI on those historical payments during his or her lifetime, as that might be an indication that those historical payments were excessive and therefore could reduce the reasonable amount that the inheriting individual may receive for some time after the inheritance (since the inheriting individual would be deemed to have received those historical excessive returns pursuant to clause 120.4(1.1)(e)(ii)(C)).

b) The deceased is deemed to have received proceeds of disposition for the shares immediately before death equal to either the fair market value or adjusted cost base under subsection 70(5) or (6), respectively. It is not clear whether such deemed proceeds may constitute an amount paid by "any person" to the deceased in respect of the source business, which is then deemed to have been paid to the individual pursuant to clause 120.4(1)(e)(ii)(C). To the extent the estate of the deceased receives distributions from the business within the calendar year of death, there may be uncertainty as to whether such distributions are considered amounts paid "for the benefit of" the deceased and therefore should be included in subclause 120.4(1.1)(e)(ii)(C)(IV). This uncertainty is compounded if the estate elects under subsection 164(6) to deem the estate's disposition of property within the first taxation year to be a disposition by the deceased. If any of these deemed proceeds on death, distributions to estate, or subsection 164(6) dispositions are deemed to have been paid to the inheriting individual by clause 120.4(1.1)(e)(ii)(C) for purpose of the reasonableness determination, it will make it very difficult or impossible to pay non-TOSI dividends to the individual after the inheritance.

c) It is unclear how clause 120.4(1.1)(e)(ii)(C) should be applied where there is more than one individual inheriting the business. For example, if the shares of an Opco are distributed to both active and inactive shareholders, it is unclear how clause 120.4(1.1)(e)(ii)(C) should be applied. Given the provision refers to "*the proportion of the relevant property*", a reasonable interpretation would be that each inheriting individual inherits a pro-rata portion of the deceased's functions performed, assets contributed and risk assumed, but in practice, it could be very difficult to make a pro-rata division for something as subjective as functions performed and risks assumed. Also, a pro-rata division will produce an inappropriate result whereby the active inheriting individual cannot receive a substantial dividend from the Opco for some period of time after the inheritance because she or he has been deemed to have inherited only a pro-rata percentage of the historical functions, asset contributions and risks assumed. On the other hand, the inactive shareholder may receive "reasonable" dividends for a short period of time merely because of the inherited functions.

   A proper *pro-rata* division of the deceased's functions performed, assets contributed, risks assumed and historical payments received will be even more difficult where individuals inherit different types of interests. For instance, assume Child 1 inherits common shares, Child 2 inherits preferred shares, and Child 3 inherits shareholder loan receivables. A *pro-rata* division may need to consider not just the face value of the preferred shares and receivables, but also the respective types of interests' priority of claims against corporate assets and other rights or attributes.

d) Another area of uncertainty is where an interest in a business is inherited by an individual aged between 17 and 24, but where the circumstances described in paragraph (a) of the proposed definition of "excluded amount" do not apply. For these individuals, subparagraph 120.4(1.1)(e)(iii) ignores functions performed unless the engagement is regular, continuous and substantial, and limits the return to the prescribed rate as applied to their contributions to and risks assumed. It is unclear how the limitations in subparagraph 120.4(1.1)(e)(iii) interact with the deeming rules in clause 120.4(1.1)(e)(ii)(C) where the interest is inherited.

While this would not solve all the issues noted, we recommend that Finance consider specifying that clause 120.4(1.1)(e)(ii)(C) will operate only to increase (rather than decrease) the amount "*paid or payable by an operating entity*" in subparagraph (b)(iii) of the proposed definition of "split portion". This would be consistent with what appears to be the relieving intent of clause 120.4(1.1)(e)(ii)(C) and would eliminate the potential downside concerns that an inheritance may impose to a specified individual who is active in the business and is otherwise entitled to a reasonable amount of income or gain.

9) Subjectivity of valuation for purpose of 2018 deemed disposition election

One of the transitional measures included in the Draft Legislation is the 2018 deemed disposition election in proposed subsections 110.6(18) and (18.1). The election enables the taxpayer to elect proceeds of disposition up to the fair market value of the property subject to deemed disposition. Penalties are built into the Draft Legislation in the form of an ACB reduction that is triggered if the taxpayer has overvalued the fair market value by more than 10% - see the formulae contained in proposed subparagraph 110.6(18)(a)(ii) and paragraph 110.6(18)(h).

It is well known that valuation of private businesses is a very subjective and uncertain exercise. The recent decision in the *Ozerdinc Family Trust* case highlights the wide range of values experts, in good faith, can determine.[8] It also highlights that the Court can come to a different conclusion than the experts. The costs award discussion provides an insight to the costs to the private business community in exercising even the level of due diligence which failed to achieve a value accepted by the Courts.[9]

Allowing only for a 10% safe harbour before imposing a penalty is thus a harsh result. Furthermore, professionally prepared valuations usually provide a range of possible values, and the common practice is to choose a mid-point between the highest and the lowest value. For private businesses, the variance between the mid-point and the lowest (or highest) value is often larger than 10% (and sometimes significantly more).

We recognize that the 10% safe harbour rule was similar to the one adopted for the election pertaining to the elimination of the $100,000 capital gains exemption in 1994, but that election was more often applied to publicly traded portfolio investments, real estate and other assets for which more reliable value data were available at much lower costs than formal business valuations.

The challenges in determining an appropriate safe harbour for valuation errors are apparent from the history of subsection 163.2(10) which applies for purposes of the third party civil penalty. Subsection 163.2(10) applies where a person determines an amount to be the correct value of a property or service, and that value is greater or less than a prescribed percentage of the value ultimately determined to be correct. Although this provision received Royal Assent on June 29, 2000, no percentage has been prescribed to date, which we take to indicate that Finance has not yet been able to satisfy itself as to an appropriate "deviation range", to use the terminology from a Department of Finance letter on this subject dated July 11, 2000.

We would note that the consequence of subsection 163.2(10) applying is solely a reversal of the onus to demonstrate a lack of culpable conduct mandating a penalty, and does not conclusively establish a penalty is warranted. It seems reasonable that the permitted deviation range for purposes of imposing a penalty should be larger.

We recommend that Finance consider restricting any penalty to situations like those addressed by subsection 163.2(11), i.e. where *bona fide* efforts were not undertaken to determine and elect at the correct fair market value, or where the excessive election arises knowingly, or under circumstances amounting to gross negligence. It might be reasonable to provide for a similar reversal of onus where the value selected falls outside any range ultimately set under regulations to subsection 163.2(10).

10) Uncertainty regarding whether a "business" is carried on

The proposed TOSI rules will apply only for taxpayers who are specified individuals. For adults, one of the conditions that needs to be met for the individual to be a specified individual is that

[8] Grimes v. R. 2016 TCC 280.
[9] 2017 TCC 113.

the income or capital gain "*can reasonably be considered … derived, directly or indirectly, from a business*" – see subclause (b)(iii)(B)(II) of the proposed definition of specified individual. Similarly, in paragraph (b) of the proposed definition of split portion, the reasonableness test is only relevant if an amount is paid or payable *"in respect of a business of, or the rental of property by, the operating entity".*

A "business" is broadly defined in subsection 248(1), and includes an "*undertaking of any kind whatever*". However, there has always been a distinction between property income and business income, and the courts have generally distinguished between the two by considering the level of services, the number and value of transactions, the time devoted to the activity, etc. This is not a bright line test. It is not clear whether the business income versus property income distinction is the appropriate test for whether an undertaking is a "business" given the broad definition provided in subsection 248(1).

A common example is a family holding shares in a corporation that only invests in publicly traded securities or private companies in which the family has no involvement. If the corporation's activities constitute a "business", then TOSI may apply to the family members. However, if it is not a business, then the proposed rules will not apply.

The consequence of getting this determination wrong is severe, since the resulting income and capital gain could be subject to TOSI, and capital gains could be recharacterized as a non-eligible dividend under proposed subsections 120.4(4) or (5). We recommend that Finance consider a clearer definition of business for the specific purpose of the proposed TOSI rules, or at least confirm in the Explanatory Notes that income and capital gains derived from a corporation, partnership or trust that earns only income from property will not be subject to TOSI or subsections 120.4(4) or (5).

11) TOSI causes additional uncertainty and complexity in connection with the valuation of interests in private businesses

In a situation where there is one class of shares, dividends will need to be paid on a *pro-rata* basis based to all holders of the issued shares. A family wishing to comply with and minimize the consequences of TOSI may consider having the capital reorganized so that the perceived reasonable amount of dividends can be paid in order to avoid the implications of TOSI. Benefit provisions of the Act (e.g. subsection 86(2)) need to be considered, and it is conceivable these rules could apply where it is known that only certain shares in the hands of certain shareholders may realistically be expected to be entitled to dividends given the novel concept of measuring "contribution" to the business when determining whether a dividend is appropriate. One can also foresee a valuation issue at the time of death if the payment of dividends on a class of shares is based on TOSI. In addition, a deceased's functions performed, assets contributed, risks assumed and historical payments received could make shares more or less attractive in terms of the application of TOSI in the hands of the inheriting individual.

We do not have a recommended solution for this issue as it seems to be an unavoidable side effect of the TOSI rules as proposed. Please consider our proposed legislative alternatives later in the submission.

12) Illustrative examples would be helpful for paragraph 110.6(12)(f)

Proposed paragraph 110.6(12)(f) reduces entitlement to the LCGE if the relevant conditions in proposed paragraph 110.6(12.1)(c) are met. Some practitioners are struggling to interpret this provision, and in particular the distinction between clauses 110.6(12.1)(c)(i)(A) and (B) and the mechanics of how the fair market value of an interest as a beneficiary under a trust changes based on trustees' decisions in respect of the distribution of income or capital and actual distribution of such income or capital. Additional complexity arises upon the interaction between this provision and existing paragraph 110.6(7)(b) in which a carve-out exists for a distribution in satisfaction of a corporation's capital interest in a trust.

It would be helpful if detailed numerical examples could be provided within the Explanatory Notes demonstrating how paragraph 110.6(12)(f) should be applied in different situations.

13) Difficulty of applying "connected individual" definition to trust beneficiaries

Where shares of a corporation are held by a trust, it may sometimes be necessary to establish whether a beneficiary is a "connected individual" to the underlying corporation for purpose of the "split portion" determination for a related individual. The beneficiary likely is not within paragraph (a) of the "connected individual" definition, because, unless there is *de facto* control, the beneficiary would not be part of a "related group" that controls, directly or indirectly, the corporation (since the shares are held by the trust, not the beneficiary). However, paragraph (b) of the "connected individual" could apply to the beneficiary if the portion of the total fair market value of the beneficiary's interest in the trust that is derived from the shares of the corporation is equal to or greater than 10 percent of the value of all outstanding shares.

Besides being a complicated concept to understand, this determination appears to involve establishing the fair market value of a beneficiary's interest in a trust, which, particularly in the case of a discretionary trust, is unsettled. We recommend adding a more straightforward criterion designed for trust beneficiaries within the definition of "connected individual".

B. Inappropriate Application of Top Marginal Rates

Under the proposed TOSI rules, a specified individual who earns split income is automatically subject to the top marginal tax rate and access to personal tax credits will be limited. This is the case even for businesses that generate an amount of profit that, if all paid to one individual, would not have caused the individual to be in the top tax bracket. The application of TOSI in such a situation could cause the family to bear an effective tax rate that is higher than they would have experienced in the absence of any income sprinkling. We are concerned that this result is disproportionately harsh, and request that Finance consider whether it is appropriate.

In an effort to illustrate the implications of these proposals, we have prepared a series of numerical examples attached as Appendix A. We would especially draw your attention to the harsh results imposed in certain circumstances on middle and lower income households.

We recommend Finance consider one of the two following alternatives to applying the top marginal tax rate, as currently proposed:

i) Instead of applying the top marginal tax rate to the relevant “excess”, introduce a rule that attributes the unreasonable amount of income or capital gains to the active business owner(s). This alternative could produce more appropriate results, as the split income would be taxed at the applicable marginal rate of the active business owner(s), which may be less than the top marginal rate while preserving the top marginal rate where appropriate.

ii) Adopt the mechanism similar to that applicable in the U.S. “kiddie” tax regime, which is to calculate tax on a child’s tax twice – once at their own marginal tax rates and again at the marginal tax rates of the parents. Whichever tax is higher is the one paid by the child. A similar rule could be adopted for the Canadian TOSI rules so that any split income or capital gain is subject to this dual tax computation.

C. Technical Issues

1) The reasonableness test in subparagraph (b)(iii) of the proposed definition of “split portion” (referred to as “subparagraph (b)(iii)” below) could result in TOSI being applied to situations which we believe are not intended targets of the Draft Legislation. Below are some examples:

   a. The effect and objective of subparagraph (b)(iii) is to limit a specified individual’s income or capital gains derived from a business to a “reasonable” amount based on the various inputs described in the subparagraph. However, the objective of a business is to generate output that exceeds the value of the inputs. By definition, a successful business will deliver returns to someone that are in excess of their contributions (in terms of functions, assets and risks assumed), and part of the return to its owners, either annually or as capital gains on an ultimate liquidation, will be subject to TOSI.

   b. For many start-up businesses, the first round of financing is typically known as a “friends and family raise” because much of the capital comes from related family members. These family member investors will make the investment to support the founder, and in most instances, that will be their only involvement. Since they are related to the founder (who, if the business is a corporation, will likely be a specified shareholder and a connected individual), each of the family member investors will likely be considered a specified individual irrespective of whether they are issued shares, debt or partnership interests of the start-up. As such, consideration will need to be given to whether the TOSI will apply to the income (dividend, interest, partnership income) realized by each of the family member investors. Even if a higher return is justified due to the high risk nature of investing in a start-up, there is a significant risk of disputes, as the CRA’s judgment may inevitably differ from the taxpayer’s judgment with respect to the portion of a significant return that may be considered unreasonable based on the four factors in subparagraph (b)(iii). If the TOSI applies to income, it will likely also apply to the eventual capital gain on disposition, and there will be no entitlement to the LCGE. If the shares are sold to a non-arm’s length party, such as the founder, it is possible that the gain will be subject to tax as a non-eligible dividend.

      On the other hand, if inadequate returns were provided to the family investors, it will likely mean that “too much” income is being earned by the founder (who will be a specified individual as well due to having family members as investors) under the reasonableness test. This will result in TOSI to the founder.

      We are concerned that the Draft Legislation may provide a barrier for new, emerging or growing businesses to obtain capital from a traditional source since there may be a distinct tax disadvantage for family members to provide capital. Given the uncertain tax result, the tax rules may create an incentive for family member investors to invest their capital in less risky investments that carry greater tax certainty such as publicly-traded shares.

c. If a shareholder is a specified individual, the reasonableness test in subparagraph (b)(iii) can apply to limit shareholder remuneration even where no income sprinkling is attempted. For example, Wife and Husband own 50 Class A common shares and 50 Class B common shares, respectively, in Opco, but Wife is the only spouse involved in Opco's business and she acts as the CEO of Opco. Wife is a specified individual because a related person (Husband) is a specified shareholder and a connected individual of Opco. As such, dividend income earned by Wife will be subject to the subparagraph (b)(iii) reasonableness test even if the dividend to Wife constitutes all of Opco's after-tax earnings and no dividend is paid to Husband.

   In applying the reasonableness test, it will have to be determined what an arm's length operating entity would have paid Wife in her role as CEO (plus her assets contribution, risks assumption, while considering historical amounts already paid to her). Anything over that amount appears to be subject to TOSI. If Opco has a very profitable year and pays out all of its after-tax earnings to Wife, a portion may be subject to TOSI because the amount could be higher than what an arm's length business would have paid to Wife, and arguably a typical arm's length business does not pay out all of their profits to the CEO, even a CEO who has invested equity in the business.

   The application of the reasonableness test in such a scenario appears to go beyond the policy objective of the proposed TOSI rules, since no income sprinkling was occurring in the first place. It also punishes owners of businesses for earning more than a "reasonable" amount of profit relative to the functions performed, assets contributed and risks assumed by the owners. If we are interpreting this rule incorrectly, and the contributions made by various shareholders are meant to determine how distributions to various shareholders should be weighed for TOSI determination purposes, this should be clarified.

d. The imposition of a reasonableness standard to shareholder returns may interfere with *bona fide* business arrangements. Owners of a business often take on different roles in the business, and the agreed-upon allocation of the business income amongst them may not necessarily reflect the arm's length value (as perceived by outsiders to the business) of the respective roles for various *bona fide* commercial reasons. However, if these owners are related, the reasonableness test in subparagraph (b)(iii) may cause TOSI to apply to some of the shareholders or partners.

   For example, two siblings start a business and each of them contributes the same amount of assets and assumes the same risks. They also receive 50% of the after-tax profit each, but one of them acts as the CEO and the other acts as the marketing manager. Since an arm's length business would typically pay a marketing manager less than a CEO, the marketing manager sibling could be subject to TOSI on a portion of his dividend income (and ultimate capital gains).

e. The reasonableness test in subparagraph (b)(iii) does not contemplate income or gains arising outside of the four specified factors. In particular, windfall amounts where no owners put in any effort or contribution. Consider the situation of a group of related investors who form a corporation or limited partnership with nominal initial capital. The corporation or partnership acquires real estate with debt financing from an arm's length financial institution with limited personal guarantees, and hires a full time individual to manage all aspects of the investment. Subsequently, the real estate was sold at a significant gain, which is distributed out to the investors (either as partnership income, or dividends if incorporated). Each of the investors is a specified individual, but none of them would meet the reasonableness standard: no functions are deemed to have been performed, limited assets contributed and limited risks assumed (because of limited liability offered by the corporation or limited partnership). As a result, it appears that all or a substantial portion of their income would be subject to TOSI.

We would be pleased to engage with Finance to further discuss how to address these issues associated with the reasonableness test.

2) Impact on business succession planning

Two common structures used to transition a business from one generation to another are (i) a so-called "wasting freeze" and (ii) a sale of shares for fair market value in consideration for a promissory note payable over time. The proposed TOSI rules cause significant concerns with either, and incentivize business owners to exit their business through a sale to an outsider rather than to family members or key employees.

a) Under a wasting freeze (a structure which has been an accepted part of the Canadian tax landscape since before capital gains were even taxable), the founder exchanges the common shares for a class of shares that are redeemable and retractable for an amount equal to the fair market value of the exchanged common shares. The exchange would usually take place on a tax-deferred basis and common shares would be issued to the next generation. Over time, the preferred shares are redeemed thereby giving rise to a deemed dividend under subsection 84(3). If the founder contributed the capital to the business, bore all of the risk and ran the business, the deemed dividends would not be subject to TOSI. If, however, the next generation had been increasingly involved in the business and have become specified shareholders and connected individuals before the exchange, there would be a question as to whether a portion of each deemed dividend of the founder from future redemption of the fixed value shares would be subject to TOSI. This seems to be an inappropriate result particularly where the founder has accepted that the tax consequences of this liquidity event would be a taxable dividend as opposed to a capital gain that is subject to tax at a more favourable rate.

b) In another common plan, the founder sells the shares to the next generation in consideration for a promissory note payable over time. If as above, the next generation was increasingly involved in the business and became specified shareholders and connected individuals prior to the sale, a portion of the founder's capital gain may be recharacterized by proposed subsection 120.4(4) into a non-eligible dividend that is subject to tax as TOSI. This will also limit the founder's ability to claim the LCGE or the 10-year capital gain reserve permitted under subsection 40(1.1).
From the next generation's perspective, the effect of the outstanding promissory note issued to the founder on the sale will likely mean that a portion of the purchase price payable for the shares is not includable in respect of the asset contribution factor when assessing the reasonableness of income or capital gains earned by the next generation, since clause 120.4(1.1)(e)(ii)(B) requires the carve-out of assets acquired in connection with financial assistance provided by a related person (founder). In addition, should interest on

the promissory note be considered unreasonably high, the founder is at risk of the TOSI being applied, while an insufficient rate of interest exposes the purchaser to the same risk.

c) Subsections 120.4(4) or (5) could also potentially apply to the sale of shares to employees (or buying back shares from employees) to the extent the seller is a specified individual and it is determined that the vendor(s) and purchasers do not deal at arm's length. For instance, Husband and Wife are 50/50 shareholders of Opco and decide to sell all of their shares to a holding company of their unrelated key employee. This is a common arrangement since using a holding company to purchase shares enables the purchase price to be paid with future corporate earnings. Since Husband and Wife are specified individuals, a portion of their capital gain could be recharacterized as non-eligible dividends to the extent the purchaser is considered to not deal at arm's length with them and the quantum of capital gain is considered unreasonable. It should be noted that the CRA has repeatedly asserted that a corporation set up to facilitate the purchase of shares ("Buycos") may, depending on the facts and circumstances, be viewed as not dealing at arm's length with the vendor,[10] and the Federal Court of Appeal decision in *Turgeon* highlights this.[11] The TOSI proposals increase the uncertainty with family succession planning, creating an incentive to seek arm's length purchasers rather than selling to family member purchasers.

These effects seem to be an unavoidable side effect of the TOSI rules as proposed, but many of our concerns would be partially alleviated by a repeal of subsections 120.4(4) and (5), as we will discuss later in this submission.

3) Conflict with family law

The notion of contribution as set out in the Draft Legislation appears to be out of step with the principles of contribution in family law.

In the event of a breakdown of a marriage, and in some cases, death, family law in each Canadian province and territory provides for an equitable division of net family property between spouses (see Appendix B for a summary). There is also the doctrine of constructive trust that has, at its root, the concept that one spouse should not be unjustly enriched at the expense of the other spouse in circumstances where the other spouse has contributed not only to the acquisition of a property but also to its preservation, maintenance or improvement.

The reasonableness test contained in subparagraph (b)(iii) of the proposed definition of "split portion", on its face, seems at odds with the theory underlying these family law concepts. The contribution made by a spouse as understood for family law purposes may be in the form of maintaining the household and looking after the children, thereby providing the enhanced opportunity for the other spouse to pursue, enhance and grow the business for the betterment of the family. Although increasingly more men are taking time to contribute to the raising of children, it is the woman who typically has the role of raising the children. As such, there may be a disparate and negative impact on women under the TOSI rules.

The contribution test also appears to ignore the fact that the family's assets are often at risk in support of the business. For example, the family home may be subject to a charge to secure debt that relates the business

[10] See for example, CRA document #2016-0669661C6 and #2013-0479402C6.
[11] See footnote 4.

We recommend that Finance consider incorporating into the reasonableness test express references to non-monetary contributions and ancillary functions that reasonably support functions relating to the source business performed by a related individual. This would go some way to address the disparate and negative impact of the proposed TOSI rules on women. We also recommend that Finance consider the family unit taxation regime as we describe in the Legislative Alternatives section of this submission.

4) Use of “specified shareholder” as a threshold

The proposed TOSI rules use the concept of “specified shareholder” in a number of provisions, but we believe that “specified shareholder” is too broad a term to be used for purposes of determining the application of TOSI. In particular, the definition of “specified individual” as it relates to income from a business carried on by a corporation, uses the existence of a related individual who is also a “specified shareholder” as a qualifying condition. The definition of “specified shareholder”, which is contained in subsection 248(1), is very broad and may result in business owners who do not appear to be targeted by the stated objective of the Draft Legislation being identified as a “specified individual” and thus subject to the proposed TOSI rules.

For example, a person who owns 3 percent of the shares of a corporation will be a specified shareholder if one or more family members also own in total 8% of the shares. In this situation, a taxpayer would need to address the potential application of TOSI to any dividend or capital gain received.

In addition, because a person who owns 10 percent of any class of a corporation’s shares is considered a “specified shareholder” of any other corporations related to that corporation, a 100% owner of Opco is a “specified individual” to the extent a relative owns more than 10 percent and controls any other corporation in the world. In fact, because the definition of “specified shareholder” deems a taxpayer to own each share of a corporation owned at that time by a non-arm’s length person, a 100% owner of an Opco will always be considered a “specified individual” if she or he has any living relative.

In a scenario where a 100% owner of an Opco is an adult and a specified individual for the reason(s) described above, dividends and interests received should not attract TOSI because subclause (b)(ii)(A)(I) of the proposed definition of “split portion” requires that a related individual be a connected individual with respect to the payor corporation. However, for income that is described in subclause (b)(ii)(A)(II) of the split portion definition, the relevant determination is whether a corporation has a related person as either specified shareholder or connected individual, which could cause TOSI to apply to even a 100% business owner.

Assume Mr. Adult is a sole shareholder of Opco, and a 100% owner of Partnership (Partnership has a nominal corporate partner, that is also wholly owned by Mr. Adult), and Partnership earns its income from providing services to Opco. Mr. Adult is a specified individual because he has a living relative who is deemed to also own all of the shares of Opco, for reasons described earlier. The partnership income earned by Mr. A is described in paragraph (b) of the split income definition, because the partnership income is derived from a related source – which it would be because the partnership provides services to a business carried on by a corporation of which a related person is a specified shareholder. Next, it needs to be determined whether the partnership income is “split portion”. The partnership income would meet subclause (b)(ii)(A)(II) of the split portion definition because the income is derived from a corporation in which a related person is a specified shareholder. Therefore, Mr. A will need to pass the reasonableness test in subparagraph (b)(iii) in order to avoid the partnership income being subject to TOSI. This appears to be an inappropriate result since Mr. Adult is the sole owner of both Opco and Partnership, but he is clearly caught by these rules solely because he has a living relative.

We are concerned that the use of the existing definition of "specified shareholder" is too low a threshold for the analysis and compliance burden arising under TOSI. Given subclause (b)(ii)(A)(I) limits the split portion associated with corporate interests to circumstances where a related person is a "connected individual" (with no reference to the "specified shareholder" requirement), we recommend removing the reference to "specified shareholder" from subclause (b)(iii)(B)(III) of the "specified individual" definition.

5) Reference to "year" in tests based on specified shareholder and connected individual

In the following proposed definitions, the relevant period where the existence of specified shareholder and/or connected individual in respect of a corporation could trigger TOSI is the "year":

i) In the definition of "specified individual", subclause (b)(iii)(B)(III) refers to "relevant year" in respect of whether a related individual is a specified shareholder or a connected individual of the corporation;
ii) In the definition of "related source", subparagraph (a)(ii) refers to "the year" in respect of whether a related person is a specified shareholder or a connected individual of the corporation receiving property or services; and
iii) In the definition of "split portion", subclause (b)(ii)(A)(I) refers to "the year" in respect of whether a related person is a connected individual of the corporation, while subclause (b)(ii)(A)(II) refers to "the year" in respect of whether a related person is a specified shareholder or a connected individual of the corporation receiving property or services.

It appears that all of the references to either "the year" or "relevant year" above refer to the calendar year, since the taxpayer subject to TOSI is always an individual. This could produce anomalies especially in the context of business succession. For instance, on July 31, 2018 Mother sells shares of Opco to Daughter for fair market value proceeds. Prior to the sale, Mother was the sole owner of Opco and was the only individual actively engaged in the business. Starting August 31, Daughter takes over all aspects of Opco's business.

It appears that Mother could be subject to TOSI if the dividend and capital gains she earns in respect of the Opco shares during 2018 exceeds what is considered reasonable based on the factors outlined in subparagraph (b)(iii) of the proposed definition of "split portion". This is because:

- Mother is a specified individual in 2018, because during the "relevant year", Daughter became a specified shareholder and a connected individual in respect of Opco;
- Mother meets subparagraph (b)(ii) of the proposed definition of split portion because during "the year", Daughter became a connected individual in respect of Opco;
- For 2018 dividends earned by Mother to escape TOSI treatment, Mother needs to meet the reasonableness test in subparagraph (b)(iii) of the proposed definition of split portion. The 2018 capital gains she earned from the disposition is subject to the same test, because of the deeming rule in paragraph (c) of the proposed definition of split portion.

We believe that subjecting a sole shareholder to potential TOSI due to a sale to a relative during a calendar year must be unintended. To avoid this anomaly, the respective tests discussed above should be applied at a point in time, rather than throughout the calendar year.

6) Basing the reasonableness test on what would be paid by "an" operating entity

The reasonableness test in subparagraph (b)(iii) of the proposed definition of "split portion" refers to the amount that would have been paid or payable by "an" operating entity dealing at arm's length with the specified individual. The rest of the subparagraph looks to the functions performed, assets contributed, risks assumed by the specified individual, and the historical amounts paid or payable to her or him. There is however nothing to import the nature or characteristic of the actual operating entity to this hypothetical operating entity.

This means that the test is looking at any business, rather than an arm's length business with the same facts and circumstances. The amount a business pays someone depends very much on the facts pertaining to that entity, e.g. a profitable business can pay more whereas a loss entity pays less, a business with no debt may be able to pay a bigger dividend than a business that is leveraged with debts that imposes restrictive covenants on capital requirements, etc. We believe that a more appropriate test would focus on the reasonable amount that "the" particular operating entity would pay an arm's length individual with the same functions performed, assets contributed, and risks assumed as the specified individual in question.

7) Reasonableness tests may require reorganization of existing legal structures

In a way, the reasonableness standards imposed by subparagraph (b)(iii) in the proposed definition of "split portion" take for granted that varying degrees of reasonable income can be streamed to the different business owners as each owner's functions performed, assets contributed, and risks assumed evolve over time. However, if the corporation only has one class of issued shares, the same amount of dividend must be paid on each share. Similarly, partnership agreements often have fixed income allocation formulas.

A typical small or medium sized business is usually set up with basic holding structures where the flexibility contemplated by the reasonableness standards is not possible. In order to properly comply with the proposed TOSI rules (in other words, to avoid TOSI), these businesses will have to reorganize their share capital or amend their partnership agreement prior to the end of 2018. This will add additional administrative burdens and costs that many business owners are unable to afford, all because they put in place a structure that was too basic to adapt to the proposed rules. Where third party owners are involved in the business, their approval may be required for such a share reorganization to proceed and this may require further complicating the structuring to safeguard their interests. We do not believe it is appropriate to burden many smaller businesses with increased reorganization costs and subject them to potential disputes on entitlement, just so that they are able to comply with the TOSI proposals.

8) Including unincorporated businesses in the proposed TOSI rules will catch unsuspecting taxpayers

The proposed TOSI rules could apply to adults earning income or capital gains from partnerships and trusts. This could cause taxpayers who enter into transactions with no tax-driven motivation to be caught under the proposed TOSI rules. This is particularly true in how these rules may apply to partnerships. Many unincorporated businesses in Canada involve some participation from both spouses or common-law partners, and many such businesses constitute partnerships because they involve two or more persons carrying on a business in common with a view to profit. Income from these "partnerships" will be considered "split income" because income is derived from a "related source" – paragraph (b) of that definition catches any business of a partnership in which a related person is actively engaged. This results in potentially one or both spouses earning income or capital gains that is split portion and subject to TOSI, even though in many cases the income allocation for these partnerships is fixed at 50/50 as a matter of law absent a partnership agreement to the contrary.

This has implications even for taxpayers who may not consider that they are carrying on businesses. For example, Husband and Wife purchase a condo for the sole purpose of resale. This constitutes an adventure or concern in the nature of trade under the jurisprudence and is therefore a "business" per subsection 248(1). Since they are carrying on a business in common with a view to profit, Husband and Wife are potentially considered partners in a partnership in respect of this venture.

As such, Husband and Wife will be specified individuals, and may be subject to TOSI on the profits from the condo resale unless the profit earned by each of them is considered reasonable based on all the factors in subparagraph (b)(iii) of the proposed definition of "split portion". For instance, if Wife performed most of the functions relating to the condo, then a portion of Husband's profit may be TOSI. Also, if part of the resale profit is simply due to rapid appreciation in real estate market values rather than to any of the functions performed by Husband and Wife, then arguably that excessive portion will be subject to TOSI as well. We suggest that this result may be unintended but is illustrative of the broad application of the proposed rules.

9) Threshold for including taxable capital gain in split income, for properties other than shares

Paragraph (e) of the proposed definition of "split income" outlines when a taxable capital gain could be split income. For taxable capital gains on the disposition of an interest in a partnership, an interest as a beneficiary in a trust (with exceptions for mutual fund trusts and subsection 143(1) trusts), and certain debt obligations, the entire taxable capital gain will potentially be split income (unless it is an "excluded amount") if any amount is included in the specified individual's split income for the year or an earlier taxation year. This is a very low threshold to meet, as even $1 of split income in the year or any previous year will potentially subject the entire capital gain to TOSI.

We appreciate that the drafters likely intended this low threshold to ensure any potential sprinkling of capital gain will be subject to the reasonableness test in subparagraph (b)(iii) of the proposed definition of "split portion". However, we would like to point out that (i) it will require individuals to review their entire holding history to ensure no amount was ever, or should have ever, been included in split income in respect of the property, including pre-2018 split income under the existing rules, and (ii) it may cause hardship to retiring unincorporated business owners.

With regard to the second point, consider the situation of a farming couple who own and operate a farm through a 50/50 partnership. Over the last few years, they have passed on some of the farming duties to their children (for no or below market remuneration) and now plan to sell the farm to the children. Each of the farming husband and wife is a specified individual, and since the partnership used free or below market labour of the couple's children in the last few years for some of the farming functions, there is likely at least a small portion of the farming partnership income allocated to the husband and wife over the last few years that should be split income. Because there was an amount of split income in respect of the farm earned by the husband and wife for the year of disposition or an earlier year, the entire taxable capital gain will need to be assessed against the reasonableness test to determine whether some portion should be subject to TOSI. Even if it is determined that only a small portion of the taxable capital gain will be caught, there may be substantial professional fees involved to make that determination.

We do not have a recommended solution for this issue, but please consider our proposed legislative alternatives later in this submission.

10) Application of clause 120.4(1.1)(e)(ii)(A) to *bona fide* businesses

Clause 120.4(1.1)(e)(ii)(A) of the Draft Legislation presumes that if (i) the principal purpose of the business is to derive income from property (including interest, dividends, rents and royalties or a similar return) or (ii) 50% of the total amounts included in income is income from property or capital gains from property, then no amount is to be attributed to the function of the specified individual. The Explanatory Notes describe new Clauses 120.4(1.1)(e)(ii)(A) and (B) as specific anti-avoidance rules that apply to exclude certain labour and capital contributions from the reasonableness test.

We are concerned about the impact of this rule on active businesses that derive income from property, such as commercial real estate, equipment rental, hotels and bed and breakfasts, etc, and particularly if they hire employees or contractors. An active business that otherwise falls outside of one described in clause 120.4(1.1)(e)(ii)(A) may find itself being inadvertently caught by the clause for a particular year if it has a substantial capital gain from the disposition of assets during that year, or if it has poor operating profits in the year such that its interest income earned from its working capital exceeds those operating profits. This is also exacerbated by the fact that gains on a sale of eligible capital property such as intangibles and goodwill are now treated as a capital gain rather than business income.

For consistency with other provisions of the Act, we recommend that consideration be given to carving out from this test a company that is not a specified investment business. Similarly, where a company holds real estate or intellectual property that is used in a related business and are separate for other reasons, such as protection from creditors, the function test should apply to both entities as a whole rather than differently for each company.

11) Simultaneous application of paragraphs (a) and (b) of the proposed definition of “excluded amount”

An important exception for “split income” is the carve-out of an “excluded amount”. The definition of excluded amount consists of two paragraphs: paragraph (a) in respect of an individual who has not attained the age of 24, and paragraph (b) in respect of an individual who has attained the age of 17. Since the connector between the two paragraphs is “and”, the applicable paragraphs that each age group need to meet in order to for income or gains to qualify as excluded amounts will be as follows:

i) Has not attained age of 17: needs to meet paragraph (a);
ii) Has attained age of 17, but has not attained age of 24: needs to meet both paragraphs (a) and (b); and
iii) Has attained age of 24: needs to meet paragraph (b).

Consequently, for taxpayers in the second category (17 to 23), their income or gains will be excluded amounts only where the subject property is acquired as a consequence of death and the income or gains are not a split portion. The curious results this produces would include:

- A young entrepreneur incorporates her or his active business at age 18 with personal savings, and is actively engaged on a regular, continuous and substantial basis in the business. However, because her or his dividend income (or capital gains) from the corporation is not from inherited property, they will all be subject to TOSI, with limited availability of personal tax credits;
- A minor inherited private corporation shares from his or her deceased parent and earns income or capital gains therefrom. While he or she was a minor, the income or capital gains would be excluded amounts because paragraph (a) refers to such inherited property. However, once he or she turns 17, income or capital gains earned on those shares may be TOSI unless he or she is engaged on a regular, continuous and substantial basis in the business – this is despite the fact that paragraph (a) covers individuals up to age 23.

We do not believe this was the intended result of the Draft Legislation and believe that paragraph (a) and (b) of the definition of "excluded amount" should not apply simultaneously to the age group of 17 to 23. We recommend that the connector between paragraphs (a) and (b) to be changed to an "<u>or</u>". This should clarify that only one of the paragraphs needs to be met for an amount to be an "excluded amount".

12) Subparagraph 120.4(1.1)(e)(iii) inappropriate for *bona fide* business owners under age of 24 in some circumstances

Clause 120.4(1.1)(e)(iii)(A) requires that functions performed by an individual who has not attained age of 24 be disregarded for purpose of the reasonableness test in subparagraph (b)(iii) of the proposed definition of "split portion", if the individual is not actively engaged on a regular, continuous and substantial basis. Many young entrepreneurs work in their business while they are attending school on a part-time or full-time basis. Others engage in their entrepreneurial activities on a part-time basis while working in other endeavours to support their fledgling businesses. These individuals will not meet the "regular, continuous and substantial" test even if they are *bona fide* entrepreneurs, resulting in top marginal rate taxation on a large portion of their business (dividend, partnership, or trust) income if they are specified individuals. Consider the real-life example of one of the world's most famous technology companies – FaceBook – that was started when its founders were attending full-time studies at Harvard University. This is hardly unique.

Clause 120.4(1.1)(e)(iii)(B) limits the assets contribution and risks assumed factors of the reasonableness test to the prescribed rates. We submit that limiting the reasonable return to the prescribed rate may not be necessary as proposed clause 120.4(1.1)(e)(ii)(B) carves out any contribution of assets acquired in connection with a related person providing any financial assistance. We are concerned that limiting the return to the prescribed rate may discourage *bona fide* investments of capital in Canadian businesses by persons in this age group.

We recommend Finance consider removing subparagraph 120.4(1.1)(e)(iii) from the Draft Legislation. We believe that the arm's length standard used in subparagraph (b)(iii) and the other anti-avoidance provisions contained in proposed section 120.4 will be sufficient to limit remuneration to specified individuals between age of 18 to 24 to the appropriate reasonable amount.

13) Application of clause 120.4(1.1)(e)(ii)(B) to prescribed loan arrangements

Many private businesses today are funded using loans between family members that bear interest at the prescribed interest rate or higher. Such arrangements are permitted under existing rules, as they avoid the application of various income attribution rules in the Act. Proposed clause 120.4(1.1)(e)(ii)(B) will cause the assets contributed by these permitted and widely-used prescribed rate loan arrangements to be ignored in determining reasonableness of income and capital gains earned by a specified individual.

We are not sure if this was intended by Finance, but we believe that a more reasonable approach would be to exclude from clause 120.4(1.1)(e)(ii)(B) assets that were acquired in connection with loans bearing interest at or higher than the prescribed rate of interest.

14) Anti-avoidance rule in paragraph 120.4(1.1)(d) could apply whenever an individual purchases public securities.

Under proposed paragraph 120.4(1.1)(d), where it can be reasonably be considered that one of the reasons that any person or partnership acquires interests in a mutual fund corporation, a mutual fund trust or a publicly listed stock is to avoid the TOSI, then those interests are deemed not to be interests in mutual fund corporation, mutual fund trust or publicly listed stock, respectively, and the taxpayer loses the protection of paragraph (b) of the definition of excluded amount.

It appears to us that the paragraph is an anti-avoidance provision intended to prevent planning whereby a private business owner transfers his or her private businesses to a mutual fund or public corporation shell. However, this anti-avoidance rule seems so broadly worded that it could apply in circumstances that we do not believe were intended to be caught. To illustrate, suppose an adult individual has an interest in a family business but, after learning about the TOSI rules, decides to invest his or her savings in shares of Pubco, a publicly listed corporation, rather than investing further in the family business. Arguably, one of the reasons for this acquisition is to avoid the TOSI, such that that the Pubco shares acquired could be deemed not to be publicly listed pursuant to paragraph 120.4(1.1)(d). The individual is a specified individual because of his/her existing interest in the family business. Because paragraph 120.4(1.1)(d) also takes away the protection of paragraph (b) of the definition of excluded amount in respect of Pubco shares and because he is an adult, none of the income or capital gains in respect of Pubco shares can ever be an excluded amount. As such, all income or capital gains he derived from the Pubco shares will be split income per paragraph (a) and (e) of the definition, and will be subject to TOSI.

We recommend narrowing the anti-avoidance rule of paragraph 120.4(1.1)(d) to target the specific type of transactions that is intended to discourage, which we believe to be the transfer of existing private business interests to a mutual fund trust, mutual fund corporation or publicly listed corporation where one of the main purposes is to avoid the TOSI.

15) Paragraph 20(1)(ww) may need to be amended

Paragraph 20(1)(ww) provides a deduction in the computation of income from business or property equal to the individual's split income for the year. We have noted the following issues with paragraph 20(1)(ww) if the proposed TOSI rules are enacted:

a. The definition of "split income" includes taxable capital gains, which is a subdivision c item. Paragraph 20(1)(ww) provides for a deduction in the computation of subdivision b income from business or property, equal to the individual's split income. Arguably, paragraph 20(1)(ww) may not include a TOSI taxable capital gain in the deduction. Furthermore, subsection 9(3) confirms that "income from property" does not include capital gains, further supporting the interpretation that the TOSI taxable capital gain would not be included in the paragraph 20(1)(ww) deduction. This results in double taxation on the capital gain, which we do not believe to be an intended result.

b. For dividend income that is split income, paragraph 20(1)(ww) subtracts the actual amount of dividend from income, but the "gross-up" of the dividend under subsection 82(1) remains in taxable income. In the past, this was not a widespread issue, since most taxpayers could generally plan to stay clear of the TOSI since the existing TOSI rules apply only to minors. Now that TOSI will apply to a much wider spectrum of taxpayers, consider whether it is appropriate that the gross-up of the dividend remains in taxable income when the actual dividend itself is already subject to TOSI tax. If it is intended (which we acknowledge could be the case, since the taxpayer remains entitled to the dividend tax credit), we recommend that this consequence be made clear in the Explanatory Notes.

c. Proposed subparagraph 120.4(1.1)(e)(i) provides an exemption from TOSI for individuals whose taxable income, without the TOSI income, already put them in the top federal tax rate bracket. Specifically, the determination looks at whether the taxable income, determined as if the paragraph 20(1)(ww) deduction for the amount of split income is read without paragraph 120.4(1.1)(e), exceeds the dollar amount referred to in paragraph 117(2)(e). Since paragraph 20(1)(ww) does not remove the dividend gross-up from taxable income, an ultra high income family could avoid the TOSI rules by paying sufficient dividends to generate a gross-up amount that, by itself, causes taxable income to exceed the paragraph 117(2)(e) dollar amount.

   Accordingly, by paying more than $534,000 of eligible dividends or more than $1,193,000 of non-eligible dividends to a specified individual,[12] TOSI will not apply and the family can take advantage of the marginal tax rates and personal tax credits of the specified individual. Permitting only ultra high-income families to income sprinkle and take advantage of marginal rates and personal credits is not consistent with the stated intention behind the proposed TOSI rules.

[12] For an eligible dividend in the amount of $534,000, the grossed-up taxable dividend after applying the 38% gross-up factor will be $736,920. The paragraph 20(1)(ww) deduction will be $534,000, leaving $202,920 of taxable income which is just higher than the $202,800 dollar limit for top personal marginal tax rates to apply. As a result, no portion of the dividend will be subject to TOSI by virtue of subparagraph 120.4(1.1)(e)(i) even if the recipient made no contribution at all to the source business. The $1,193,000 non-eligible dividend amount is arrived in a similar manner, using a 17% gross-up factor.

16) TOSI and denial of LCGE claim for beneficiaries of testamentary trusts

Proposed clause 120.4(1.1)(e)(ii)(C) applies to an individual who acquires property as a consequence of the death of another person, and it deems the inheriting individual to have inherited the functions performed, assets contributed, and risks assumed by the deceased, and it also deems the person to have received the historical payments made to the deceased. In most cases, clause 120.4(1.1)(e)(ii)(c) should act as a relieving provision to allow the inheriting individual to meet the reasonableness test in subparagraph (b)(iii) of the proposed definition of “split portion” in respect of income and capital gains earned from the inherited property. However, clause 120.4(1.1)(e)(ii)(C) fails to apply if the individual is inheriting the property as a beneficiary of a testamentary trust that holds legal title to the property.

a) Where a property is transferred from a deceased to a testamentary trust, income and capital gains earned from the property will be received by the testamentary trust which may allocate that income and capital gains to beneficiaries of the trust. If the beneficiary is a “specified individual” and the income or capital gains fall into the proposed definition of “split income” (e.g. income or gains from private corporation shares) the income or capital gains will be subject to TOSI unless they constitute “excluded amounts”. For an adult beneficiary, this means having to meet the reasonableness test in subparagraph (b)(iii) of the split portion definition.

   Unless the adult beneficiary is actively involved in the business starting immediately after the deceased passed away (and even this may not be sufficient, if significant amounts were paid to the deceased from the business while she or he was alive), the beneficiary will not be considered to be entitled to any reasonable income or capital gains. There is no provision in the Draft Legislation that imports functions performed, assets contributed, or risk assumed by the deceased to the beneficiary. Clause 120.4(1.1)(e)(ii)(C) cannot be relied on because that clause only applies where an individual acquires property as a consequence of death – this is not the case here, since the beneficiary is simply allocated an income or capital gain from the testamentary trust. Subsection 248(8)’s expanded meaning of what constitutes an acquisition of property “*as a consequence of the death*” is also of no assistance, because it does not actually deem a beneficiary to have acquired the property of a testamentary trust.

   As a result, the income or capital gains allocated to a non-active beneficiary will be entirely subject to the top marginal tax rate, with limited personal tax credits available, under the proposed TOSI rules. If the policy intent of proposed clause 120.4(1.1)(e)(ii)(C) is to provide relief to an inheriting individual, it is inconsistent to deny the same relief for beneficiaries of a testamentary trust and we recommend that this should be addressed to provide consistency.

b) A testamentary trust under which the deceased’s spouse or common-law partner was entitled to receive all the income or capital gain during his or her lifetime should be considered an eligible LCGE trust. If the trust sells qualified small business corporation shares at a capital gain, proposed subsection 104(21.2) and existing subsection 104(21) will permit the trust to designate that capital gain to be the beneficiary’s capital gain on a disposition of a capital property that is qualified small business corporation shares.

Even though the designation under subsections 104(21.2) and (21) is permitted, the beneficiary still has to qualify for a deduction under subsection 110.6(2.1). However, proposed paragraph 110.6(12)(d) denies entitlement to the LCGE to the extent the capital gain would be subject to TOSI in the hands of the beneficiary. If the beneficiary is a specified individual, the capital gain would be split income unless it is a split portion. For the capital gain to be split portion, the amount must meet the reasonableness test contained in subparagraph (b)(iii) of the definition of "split portion".

The same problem will arise in that clause 120.4(1.1)(e)(ii)(C) cannot apply to import the functions performed, assets contributed, and risks assumed. Unless the beneficiary herself or himself contributed sufficiently to the business, the beneficiary will always be subject to TOSI on the allocated capital gain and will not be entitled to the LCGE. We believe this is inconsistent with the legislative intent of the definition of eligible LCGE trust and clause 120.4(1.1)(e)(ii)(C). Consider also that an estate itself already is not permitted to designate a capital gain qualified for the LCGE because an estate cannot be an eligible LCGE trust. This issue with a testamentary trust further compounds the harsh result that arises in the context of post-mortem situations.

To resolve the issues identified, we recommend that clause 120.4(1.1)(e)(ii)(C) be expanded to include an individual beneficiary of a testamentary trust.

17) Overly broad application of joint and several liability for 17 to 24 year olds

Subsection 160(1.2) of the Draft Legislation provides that for a specified individual who has attained age 17, but not age 24, before the year, a related individual (the "particular individual") will become jointly and severally liable for the TOSI of the specified individual to the extent the particular individual is an "other individual" referred to in paragraph (b) of the definition of specified individual.

For businesses in which a large number of related persons are involved, this provision results in each of them being jointly and severally liable for the TOSI of a family member between the ages of 17 and 24 years. As noted earlier, it is not clear who is to determine the unreasonable portion of income, dividend or capital gain. This may be inappropriate in situations where it is unrealistic for each of the family members to have sufficient knowledge to assess each other's functions, contributions, and risks, or to be able to control or influence each other's income tax return preparation. We would be happy to discuss with Finance the matter of joint and several liability in the context of a discussion regarding who is to determine what is subject to TOSI.

18) Lack of a clause 120.4(1.1)(e)(ii)(C) equivalent for property acquired upon divorce or separation

Proposed clause 120.4(1.1)(e)(ii)(C) is a relieving provision that permits an adult individual who acquires a property as a consequence of the death of another person to inherit the functions performed, assets contributed, risks assumed by the deceased (and the historical amounts paid to the deceased) for purpose of the reasonableness test in subparagraph (b)(iii) of the proposed definition of split portion. We believe that the same reasons behind this relieving provision are also applicable for individuals who acquire a property as a consequence of a divorce or a separation. Just like inheritance, in a divorce or separation scenario, a person is sometimes thrust into ownership of a business with no phased succession or transition. Without a relieving rule like clause 120.4(1.1)(e)(ii)(C), the person acquiring business interests in this manner may not qualify for a reasonable return (or only qualify for a small reasonable return) from the business for the first several years of acquisition if he or she was not previously active in the business. Also, the majority of the previously non-active spouses or common-law partners receiving business interests upon divorce or separation are likely female, and they will be disproportionately harmed by the lack of such relieving provision.

For settlements on divorce or separation taking place prior to July 18, there is a concern about the effect of TOSI on the after-tax income of a former spouse which would have been a critical part of a settlement. TOSI will apply in circumstances where children continue to be shareholders of a company post-divorce with the result that the former wife would be a specified individual and the children would be connected individuals. We are advised that family law lawyers are considering whether the Draft Legislation is a change of circumstance necessitating a review of settlements. In circumstances where it is, there will be increased cost and an increased burden on the courts.

19) Issues arising from proposed subsections 120.4(4) and (5)

Below are a number of consequences that could result from proposed subsections 120.4(4) or (5) that we believe were not intended.

a. When a shareholder of a private corporation dies, the shares held by the deceased are transferred by operation of law to his or her estate. To the extent a spousal rollover under subsection 70(6) is not available, the deceased is deemed by paragraph 70(5)(a) to have disposed of the shares immediately before death. Paragraph 70(5)(b) then deems the estate to have acquired the shares at the time of death. As discussed earlier in the submission, it is unclear whether proposed subsection 120.4(4) could apply to a capital gain arising from the paragraph 70(5)(a) deemed disposition if the deceased happens to be a specified individual. For this discussion, we will assume that a transfer from the deceased to the estate constitutes a transfer to a non-arm's length person, which means that subsection 120.4(4) could apply to the deceased.

   If subsection 120.4(4) applies to a deceased private corporation shareholder who is a specified individual, the reasonableness test in subparagraph (b)(iii) of the proposed definition of "split portion" will need to be applied to the amount of the capital gain arising from the deemed disposition under paragraph 70(5)(a). Any portion of the capital gain exceeding the reasonable amount will be recharacterized into a non-eligible taxable dividend subject to the top marginal tax rate.

   It would appear that despite the recharacterization of the paragraph 70(5)(a) capital gain, there is still a basis adjustment on death to the fair market value under paragraph70(5)(b). This should permit the estate to redeem the high basis shares within one taxation year of death and elect under subsection 164(6) to deem the resulting capital loss to be a capital loss of the deceased. Even though subsection 111(2) allows this deemed capital loss to be deducted against any income of the deceased in the terminal year, it is of only of limited benefit against the subsection 120.4(4) deemed dividend. This is because the actual amount of the deemed dividend will have been excluded from income pursuant to paragraph 20(1)(ww), leaving only the subsection 82(1) gross-up amount of the dividend in net income for tax purposes. The net capital loss deduction could offset the subsection 82(1) amount completely, but cannot reduce the TOSI tax on the subsection 120.4(4) dividend.

The result is that the estate of a specified individual will be forced by the proposed TOSI rules into a double taxation situation in respect of any portion of the capital gain considered to be unreasonable. This could be because the quantum of the deemed disposition capital gain exceeds what an arm's length business would have paid to the deceased, based on functions performed, assets contributed or risks assumed by the deceased, or it could be because the corporation has already paid "too much" dividends to the deceased in the past. Either way, we believe that forcing an estate into a double tax situation is an overly harsh result, particularly in light of the fact that the proposed amendment to section 84.1 eliminates the previously acceptable "post-mortem pipeline" as a planning tool.

b. Subparagraph 120.4(1.1)(e)(i) exempts a specified individual who is already subject to the top marginal tax rate from the application of TOSI, by deeming the individual's split income to be nil. However, this exemption does not protect the specified individual from the recharacterization provision in proposed subsections 120.4(4) and (5).

   Subsection 120.4(4) or (5) applies to any capital gain arising on a disposition of private corporation shares to a person with whom the specified individual does not deal at arm's length. Paragraph (b) of both subsections 120.4(4) and (5) provides an exception for minors who inherited the shares in a manner described in paragraph (a) of the proposed definition of "excluded amount". For adults, paragraph (c) of both subsections 120.4(4) and (5) provides an exception for pre-2018 dispositions or the portion of capital gains considered reasonable based on the test described in subparagraph (b)(iii) of the proposed definition of "split portion". None of the conditions and exceptions in subsection 120.4(4) or (5) makes reference to split income. Accordingly, subparagraph 120.4(1.1)(e)(i) cannot prevent the application of subsection 120.4(4) or (5) for specified individuals who are already subject to the top marginal tax rate without the capital gain.

To address the concerns in (i) and (ii) above, we recommend that Finance consider revising proposed subsections 120.4(4) and (5) to specify that these subsections do not apply to any taxable capital gain that arises as a consequence of the death of any individual, and that they do not apply to any specified individual whose split income for the year is deemed to be nil because of subparagraph 120.4(1.1)(e)(i). Further, we recommend that Finance consider whether the interaction between subsection 120.4(4) or (5) and other provisions of the Act, such as section 84.1, may yield unintended results.

20) Overlap of subsections 120.4(4) and (5) with the proposed TOSI rules

The current subsections 120.4(4) and (5) were enacted in 2011 to prevent minors from selling private corporation shares to a non-arm's length person in order to trigger capital gains which were outside of the existing TOSI rules. Given that any unreasonable portion of capital gains will be subject to TOSI, the LCGE will not be available in respect of such portion of capital gains, and the proposals to amend section 84.1 and introduce section 246.1 will have addressed corporate surplus stripping issues, it appears to us that proposed subsections 120.4(4) and (5) may no longer be required.

Dispositions of shares by an adult to a non-arm's length purchaser is a very common practice that is likely to be motivated by normal commercial and succession reasons. In fact, proposed subsections 120.4(4) and (5) would encourage the sale of a business to a person outside of the family: sell to family and have all or a portion of the gain treated as a non-eligible dividend taxed at top marginal rates, versus sell to an outsider and have the certainty of knowing that the gain will be treated as a capital gain taxed at top marginal rates. This could incentivize owners of private companies to sell their shares to third party buyers, including non-residents of Canada or public companies.

Proposed subsections 120.4(4) and (5) are particularly inequitable when compared to the taxation of capital gains for someone who is not a business owner, who generally will never be subject to such a recharacterization of a gain irrespective of whom she or he disposes of property to. Consider also the treatment of employee stock options. An employee is able to achieve tax treatment that is equivalent to a capital gain (albeit with no LCGE on value accrued prior to exercise) from a stock option for each option that he or she is granted (perhaps granted and exercised on an annual basis) provided the conditions of the Act are met. In our view, it is inappropriate that family businesses cannot achieve a similar result, especially on the legitimate transfer of a business.

We recommend that Finance consider removing subsections 120.4(4) and (5) from the Draft Legislation, since any unreasonable amount of capital gain is already subject to TOSI and is denied the LCGE.

21) Proposed LCGE elimination exceeds LCGE otherwise claimable

Proposed subsection 110.6(12) will reduce the individual's entitlement to the LCGE in situations described in paragraph (a) to (f) of the subsection. However, under paragraph 110.6(12)(d) as currently drafted, twice the amount necessary to remove the offending entitlement is in fact removed.

The LCGE is provided in subsections 110.6(2) to (2.2), and very generally speaking it is the individual's taxable capital gain (i.e. 50 percent of the capital gain) from the disposition of qualified farm or fishing property or qualified small business corporation shares. The lifetime allowable limit for the LCGE is $500,000 for qualified farm or fishing property and $417,857 (2017 amount, indexed for each subsequent years) for qualified small business corporation shares. In other words, the deduction of the LCGE by an individual is generally limited to the taxable capital gain and the lifetime limit amount.

Under proposed subsection 110.6(12), the amount of the reduction of the LCGE will be:

- the amount of the capital gain - paragraphs (a) and (b),
- the amount by which fair market value at a certain time exceeds cost amount - paragraphs (c) and (e),
- twice the amount of taxable capital gain – paragraph (d), and
- a pro-ration of an amount that is an increase in fair market value - paragraph (f).

Each of the reductions in paragraphs (a) to (f) of subsection 110.6(12) will reduce the LCGE by twice the LCGE otherwise claimable on the disposition. For instance, an individual sells Stock A and Stock B, realizing a capital gain of $400,000 and $300,000, respectively. Both Stock A and Stock B are qualified small business corporation shares, but none of the capital gain on the disposition of Stock B is considered reasonable under the test in subparagraph (b)(iii) of the definition of "split portion" such that $150,000 of the taxable capital gains constitutes split income.[13]

Under existing law, the individual would report $350,000 of taxable capital gain, i.e. ($400,000 + $300,000) x 50 percent, and may potentially claim a LCGE of up to $350,000 to completely shelter the taxable capital gain. The impact of the proposed rules will be such that the individual is entitled to a maximum LCGE claim of $50,000, i.e. $350,000 – (2 x $150,000). This means that the individual is not only subject to the top marginal tax rate and loses LCGE entitlement on the $150,000 taxable capital gain for Stock B, but the individual also loses $150,000 of the LCGE entitlement relating to the $200,000 taxable capital gain for Stock A.

We do not believe this is intended, and we recommend that the reduction in each of the paragraphs of proposed subsection 110.6(12) be halved.

22) Proposed LCGE elimination prevents the use of the LCGE for "good" taxable capital gain in the same year

The effect of proposed subsection 110.6(12) is to reduce the amount of LCGE deductible under subsections 110.6(2) to (2.2) by an individual for a taxation year, to the extent a capital gain falls into one of the paragraphs in the subsection. This could limit an individual's ability to claim the LCGE on a capital gain that falls outside of any of the paragraphs of subsection 110.6(12) if that capital gain arises in the same year as a capital gain that offends one of those paragraphs.

To illustrate this problem, assume an individual sells Stock C and Stock D, realizing a capital gain of $1,000,000 and $1,200,000, respectively, in the same year. Assume the entire capital gain relating to Stock C was attributable to a period when Stock C was held by a trust that is not an "eligible LCGE trust". Proposed paragraph 110.6(12)(e) will reduce the amount of LCGE that may be deducted by the individual for the year by $2,000,000 (or $1,000,000 if our recommendation in item 21 is adopted), which is higher than the maximum LCGE that may be claimed for the year. Consequently, the individual cannot claim the LCGE in respect of any capital gain for the year, even though the capital gain on Stock D should be a "good" capital gain. Similar results could arise on a disposition of a single property if the amount of capital gain is partially reasonable and partially unreasonable; the unreasonable portion could reduce the individual's ability to claim the LCGE on the reasonable portion.

We do not believe this is intended. We recommend that the mechanics of proposed subsection 110.6(12) be revised so that, rather than reducing the amount of LCGE deductible by an individual, it reduces the taxable capital gain described in paragraph 110.6(2)(d) or paragraph 110.6(2.1)(d). This should prevent the LCGE from being claimed on those capital gains intended to be within the scope of the rule while permitting the LCGE to be claimed on other capital gains.

23) Decrease in value after the "particular time" or "acquisition time" described in proposed paragraphs 110.6(12)(c) and (e)

[13] $150,000 is 50 percent of the $300,000 capital gain on the disposition of Stock B.

Proposed paragraph 110.6(12)(c) reduces the LCGE that may otherwise be deductible by the portion of a realized capital gain that is attributable to a time that is before the "particular time", being the time the individual claiming the LCGE attains age 18. Similarly, proposed paragraph 110.6(12)(e) reduces the LCGE by the portion of a realized capital gain that is attributable to a time that is before the "acquisition time", being the time a person acquires the disposition property (or a substitute) from a trust that is not an eligible LCGE trust under a subsection 107(2) rollover.

Neither paragraph110.6(12)(c) nor (e) has a relieving mechanism to account for a decrease in the fair market value of the property in question occurring after the "particular time" or "acquisition time", respectively. For example, assume that a share with cost base of $0 was worth $100 when the individual owner turned age 18, but after that time, the share value dropped to $20. Assume that over the succeeding 30 years, the value of the share increases to $130 and the share is sold by the individual at a time when it qualifies as a qualified small business corporation share. Proposed paragraph 110.6(12)(c) will prevent the holder from claiming any LCGE. If our recommendation in item 21 is adopted, then $15 of the taxable capital gain will be entitled to the LCGE. However, even this appears to be inappropriate since the share appreciated in value from $20 to $130 after the individual turned 18 and this appreciation may have been entirely attributable to the individual's contributions.

We recommend that an additional provision be added to allow a taxpayer to make a designation to reduce the "fair market value" referred to in proposed paragraphs 110.6(12)(c) and (e) at any time after the "particular time" and "acquisition time", respectively, to reflect the fair market value of the property at that designated time. In the example above, the individual would have been able to designate the "fair market value" in paragraph 110.6(12)(c) to become $20, so that a LCGE of $55 could be claimed. The designation should be permitted to be filed at any time after the designated time, since paragraphs 110.6(12)(c) and (e) look-back to periods before the announcement of these proposals, and because valuation of private businesses is subjective and difficult to determine with certainty.

24) Proposed paragraph 110.6(12)(c) and (e) and qualified farm or fishing property

Proposed paragraphs 110.6(12)(c) and (e) could provide inappropriate results for qualified farm or fishing property. Because qualified farm or fishing property can be transferred at less than fair market value, either during a farmer/fisher's lifetime or at death, a disposition at fair market value is not common. Therefore the exception in subparagraph 110.6(12.1)(a)(ii) often will be inapplicable to transfers occurring after the recipient of property has reached age 18. As an example, consider the following facts:

- The MacDonald family owns farmland acquired by homesteading, which has been in the family since the 1800s. On January 1, 1972, a particular parcel had a value of $20,000, and was held by, and farmed by, Donald.
- In 1984, Donald passed the land on to his daughter, Anita. The land had appreciated in value, but the property was transferred by way of gift, and no gains were realized.
- In 1986, William, Anita's son, was born. William turned 18 in 2004. By this time, the land was worth $750,000.
- In 2014, Anita sold the land to William. It was worth $1.5 million, but the transfer was undertaken at a value of $1,020,000 and Anita used her LCGE to offset the $1 million gain.

- In 2019, William sells the land for $1.72 million.

William's taxable capital gain is $350,000, i.e. 50 percent of $700,000. Under existing rules, William would be entitled to claim a LCGE of up to $350,000 to shelter this taxable capital gain. However, by virtue of proposed paragraph 110.6(12.1)(a), he meets the relevant conditions for application of proposed paragraph 110.6(12)(c). Therefore, William's entitlement to the LCGE is reduced by the excess of the land's fair market value at the start of 2004 ($750,000) less its cost at that time ($20,000). This eliminates William's ability to claim the LCGE. Even if our recommendation in item 21 is adopted, the reduction to William's LCGE limit would exceed his taxable capital gain on the sale. This does not seem to be an appropriate result.

We believe that the unique ability to transfer qualified farm or fishing property on a tax-deferred basis through the generations make these properties unsuited for the application of paragraph 110.6(12)(c), and, in a broader sense, the proposed TOSI rules. If gains can be deferred through several generations, it appears inappropriate that capital gains that accrued in the hands of an active farmer or fisher of a previous generation become subject to TOSI in the hands of a non-farmer/fisher who has inherited or acquired the property on a tax-deferred basis.

It is our understanding that the policies underlying the provisions facilitating intergenerational transfer of farming and fishing property, and those providing the $1 million LCGE for Qualified Farming and Fishing Property, are unchanged. Assuming this is so, and to avoid the complexity of potentially having to ascertain fair market values of farm or fishing property from a distant past, we recommend that qualified farm or fishing property be excluded from the application of the proposed TOSI rules and proposed subsection 110.6(12) altogether.

Alternatively, we recommend that property received by a taxpayer in circumstances where any of the subsections 73(3), 70(6) or 70(9) applied be excepted from proposed subsection 110.6(12). If that is considered too broad an exception, we recommend that the reduction to the LCGE under proposed paragraphs 110.6(12)(c) and (e) be decreased for any amount determined under subparagraph 40(1)(a)(i) in respect of the disposition property (or property for which it is a substitute) by any person or partnership at a time that is after the "particular time" or "acquisition time", respectively. Should our recommendation in item 21 be adopted, the reference to subparagraph 40(1)(a)(i) should be to clause 3(b)(i)(A) instead.

25) Capital gains realized by an estate and allocated to beneficiaries denied LCGE

As currently drafted, capital gains realized by an estate that are allocated to beneficiaries will not be eligible capital gains of a trust for purposes of the LCGE unless the estate is an eligible LCGE trust. As an estate does not appear able to meet this definition, any gains accruing from the date of death to the date the assets are transferred to the LCGE trust will not be eligible for the LCGE. This seems to be an inappropriate result. It also subjects the beneficiaries to another, possibly costly, valuation of these assets.

We believe that an eligible LCGE trust should include an estate that is a graduated rate estate to be consistent with the provisions of proposed clause 120.4(1.1)(e)(ii)(C) and the scheme of the graduated rate estate rules, which treat the graduated rate estate as an extension of the deceased individual (e.g. entitlement to marginal tax rates). It also bears noting that, except for property which will pass to a LCGE trust (such as a spousal trust), these assets will have been deemed disposed of at fair market value by the deceased, so significant gains in the graduated rate estate seem unlikely, albeit possible.

26) Overlap for LCGE limitation provisions for trusts

The combination of the proposed definition of an "eligible LCGE trust" and proposed paragraphs 110.6(12)(e) and (f) precludes an individual from claiming the LCGE for any gains accrued in the trusts (except for the very narrow exception for an LCGE trust). It appears that these provisions are unnecessary to address the mischief targeted by these proposals because proposed paragraphs 110.6(12)(a), (c), and (d) already deny the claiming of LCGE by minors, or by adults who fail the reasonableness standards set out in subparagraph (b)(iii) of the proposed definition of "split portion."

Due to this overlap, the only additional effect that the "eligible LCGE trust" rules and proposed paragraph 110.6(12)(e) and (f) achieve is to deny the LCGE for adults earning a "reasonable" capital gain. We do not believe this is a mischief targeted by the Draft Legislation. Assets often are held by trusts rather than directly by beneficiaries, for valid non-tax reasons, including disability or impairment, a lack of financial responsibility, preservation of value for future generations, substance abuse or similar issues, and creditor exposure. A person active in a business, but whose interest in the business is held through a trust for these reasons, should not be denied the ability to claim the LCGE.

We believe that the denial of the LCGE solely because assets are held in a trust, rather than directly, is not appropriate, and we recommend that Finance consider removing the rules relating to eligible LCGE trusts and paragraphs 110.6(12)(e) and (f).

27) 2018 LCGE transition election

Proposed subsections 110.6(18) and (18.1) provide a transitional rule by allowing "eligible taxpayers" to elect to be deemed to have dispose of an "eligible property" for a designated amount of proceeds of disposition. We have identified a number of technical issues and potentially inappropriate outcomes in the application of these two subsections.

a. If an eligible taxpayer makes an election under subsection 110.6(18) for subsection 110.6(18.1) to apply, the eligible taxpayer will be deemed to have disposed of the eligible property and reacquired it immediately afterwards. Although paragraphs 110.6(18.1)(d) and (e) prevent proposed subsection 110.6(12) and paragraph (e) of the split income definition from applying to the taxable capital gain arising on this deemed disposition, proposed subsections 120.4(4) and (5) could still potentially apply to situations involving qualified small business corporation shares.

   As discussed earlier, subsection 120.4(4) could be interpreted to include a deemed disposition and reacquisition by the same individual – if the individual is factually not dealing at arm's length with herself or himself, which should generally be the case. Therefore, if the eligible taxpayer is an individual who is a "specified individual", proposed subsection 120.4(4) may convert the capital gain realized on the deemed disposition into a non-eligible taxable dividend to the extent the quantum of the capital gain is not reasonable according to the test contained in subparagraph (b)(iii) of the proposed definition of "split portion". As a result, any individual not active in the business will not be able to claim the LCGE (since the capital gain would be recharacterized as a dividend). This would in effect nullify the purpose of the election which is to provide transitional relief for individuals who will no longer qualify for the LCGE after 2017.

If the eligible taxpayer is a trust, and the capital gain realized on the deemed disposition is allocated to an individual beneficiary who is also a specified individual, it appears certain that proposed subsection 120.4(5) will apply where the beneficiary is not active in the business. Subsection 120.4(5) applies where the disposition is to "*a person with whom the specified individual does not deal at arm's length*". Under paragraph 251(1)(b), a personal trust and its beneficiary are deemed not to deal at arm's length with each other. Therefore, the deemed disposition and reacquisition by the trust under subsection 110.6(18.1) will be a disposition to a person not dealing at arm's length with the beneficiary. As a result, it appears that the LCGE can never be claimed by a beneficiary of a trust electing under subsection 110.6(18) where the beneficiary is not active in the business.

We do not believe this is intended and we recommend that the effect of electing under subsection 110.6(18) should include the non-application of subsections 120.4(4) and (5) to the taxable capital gain arising on the election.

b. We believe that there could be circumstances where a previous transaction may possibly cause subsection 69(11) to apply in the event of an election under subsection 110.6(18). We recommend that the subsection 110.6(18) election be deemed not to result in a "subsequent disposition" or an "arrangement for a subsequent disposition" for the purpose of subsection 69(11).[14]

c. For purpose of the subsection 110.6(18) election, the definition of "eligible property" excludes any property subject to attribution rules under sections 74.2, 74.3, 75 or 75.1. If the individual who transferred the property to the eligible taxpayer, thus causing the above-mentioned attribution rules to apply, has not herself or himself claimed the LCGE, neither the transferee nor the transferor would be entitled to take advantage of the subsection 110.6(18) election to claim the LCGE. This appears to retroactively eliminate the family's access to the LCGE.

   While we recognize that this exclusion in the eligible property definition is to prevent a family from "doubling-up" on LCGE entitlement simply by transferring property to a minor, a spouse or a trust, we believe it is not appropriate that an entire family lose the ability to claim the LCGE under the deemed disposition election in 2018. This is

[14] If qualified farm or fishing property is transferred to an eligible taxpayer on a fully or partially tax-deferred basis in 2015, 2016, or 2017, there is a risk that subsection 69(11) could apply due to the eligible taxpayer's election under subsection 110.6(18). Subsection 69(11) causes a taxpayer who has disposed of property on a tax-deferred basis to recognize proceeds at fair market value if one of the main purposes of the series of transactions is to obtain the benefit of (i) any deduction available to a non-affiliated person in respect of a subsequent disposition of the property, or (ii) a tax exemption available to any person on income arising on a subsequent disposition of the property. Subsection 69(11) will not apply if the subsequent disposition is three years or more after the tax-deferred transfer.

If the subsection 110.6(18) election is made by an eligible taxpayer on a qualified farm or fishing property acquired on a tax-deferred basis in 2015, 2016 or 2017, subsection 69(11) may possibly apply to trigger full recognition of capital gains for the transferor of the property. This essentially has the effect of disallowing these taxpayers access to the subsection 110.6(18) election (especially the ones who acquired the property during 2016 or 2017). We do not believe this is intended.

especially so if the transfer occurred prior to the July 18, 2017 announcement date of the proposal.

Therefore, we recommend that the proposed definition of "eligible property" be modified so that the exclusion for property subject to the aforementioned attribution rules will only apply to the extent any LCGE has been, and will be, claimed by the property transferor before the end of 2018.

d. The subsection 110.6(18) election can be made by trusts that meet the proposed definition of an "eligible taxpayer". By making the election, the trust would be entitled to allocate the resulting taxable capital gain to individual beneficiaries and make designations under subsections 104(21) and (21.2) to allow the beneficiaries to claim the LCGE.

   The challenge from a trust law perspective is that a trustee can make a distribution of income or capital only to the extent permitted under the terms of the trust. Where the trust actually disposes of property for proceeds, the trustee would be able to make a distribution to the beneficiaries in respect of the capital gain, the form of which would ordinarily be capital unless the terms of the trust defined it otherwise.

   Where the trust has income for tax purposes (such as a deemed/elected capital gain) the trustee may not be able to allocate the capital gain to a beneficiary unless (i) the income is defined in the trust to mean income for tax purposes; or (ii) there is a specific power enabling the trustee to make a distribution of an amount that is deemed income for tax purposes. Therefore, the ability to use the proposed subsection 110.6(18) election will be dependent on the terms of the trust. In addition, the trustees would not be able to complete the T3 return on a basis that an allocation had been made because the requirements of 104(24) would not have been met.

   The election is made in respect of a disposition day (as defined in proposed 110.6(17.1)). Accordingly, a trustee would have to decide on a disposition day in 2018 and, as required by 104(21.2), make an amount payable to a beneficiary before the end of 2018.

   In anticipation of an election, a trustee might consider whether a variation of the trust is required. The issue here, however, is that if a court order is required, there may not be sufficient time to obtain it before the election is required to be made. In addition, the process for obtaining the court order (at least in some provinces) would include obtaining the consent of every adult beneficiary who has capacity which in itself may be problematic.

   We would like to engage in a discussion with Finance to explore alternatives to achieve the overall objective of enabling the beneficiaries of family trusts to benefit from this transitional rule.

e. There is no relief in respect of the alternative minimum tax that may arise if an eligible taxpayer elects a deemed disposition pursuant to subsection 110.6(18.1). If the eligible taxpayer has little or no other income for the seven years subsequent to 2018, some or a portion of the alternative minimum tax may be unrecoverable. It is unclear to us whether this is intended, but we assume the purpose of subsection 110.6(18) is to allow a taxpayer to step up cost base without a tax cost if the taxpayer has a remaining LCGE balance. For elections related to qualified farming or fishing property held by minors, it seems very unlikely that younger individuals will have income sufficient to recover any alternative minimum tax. Furthermore, because the election gives rise to a deemed gain rather than an actual gain, the electing taxpayer will have no actual proceeds from which to fund any alternative minimum tax.

We recommend that capital gains arising from a subsection 110.6(18.1) election be exempt from the application of alternative minimum tax if the intent is to encourage a broad spectrum of taxpayers to take advantage of this transitional rule. As many benefits are computed based on net income, and so will be affected by this election, we recommend that consideration be given to alleviate this effect as well.

f. A late filing of the subsection 110.6(18) election attracts a late-filing penalty calculated under proposed subsection 110.6(29). This late filing penalty is significantly higher than any other late filing penalty in the Act. Where an election is made to access the maximum LCGE, the penalty is $1,393 per month ($1,667 for the maximum LCGE for farming and fishing property). In contrast, the late-filing penalties for other elections in the Act ranges from $41.67 to $100 per month. The 1994 capital gain exemption election on which this proposed penalty is based on was only $166.67 per month.

   We believe that this late filing penalty is excessive, especially taking into account the accuracy standard required on valuation (a 10% margin of error before basis is reduced). We recommend that Finance consider reducing this penalty to be consistent with other late-filing penalties contained in the Act.

28) Insufficient time for reorganizations to take advantage of proposed 2018 transitory measures

One of the conditions to qualify either for the deemed disposition election under subsection 110.6(18.1), or for subsection 110.6(30.1) in respect of an actual disposition, in 2018 is that the relevant property must be owned continuously by the individual or trust from the end of 2017 until the time of disposition. Accordingly, any reorganization involving transfers of shares in order to take advantage of these two 2018 transitory measures, particularly in terms of "purification" planning to ensure the shares qualify for qualified small business corporation shares status, must occur prior to the end of 2017. Given the proposals were announced on July 18, 2017, taxpayers have very little time to plan and undertake necessary transactions. Moreover, taxpayers and their advisors are placed in a difficult position as they would be acting on proposed measures that remain subject to comment during the consultation period, and may not become law in their proposed form.

We recommend that the effective date of the proposed limitations on claiming the LCGE be delayed until the start of a calendar year not less than six months after the legislation receives Royal Assent, and the transition election be applicable for that calendar year.

29) Denial of tax credits for vulnerable Canadians subject to TOSI

If TOSI applies to a specified individual, existing subsection 120.4(3) limits the availability of personal tax credits (other than dividend tax credits and foreign tax credits) to shelter any tax owing under TOSI. This denial seems especially harsh for vulnerable Canadians who might otherwise qualify for disability tax credits, and/or credits for medical expenses. We do not believe this is intended by Finance, and recommend Finance consider allowing certain personal tax credits be available against tax owing under TOSI.

30) Subsection 74.4(2) becomes redundant

Subsection 74.4(2) was enacted to discourage individuals from transferring or lending property to a corporation with a main purpose of benefiting the individual's spouse or non-arm's length minors. If the proposed TOSI rules are to be enacted, we submit that subsection 74.4(2) will become redundant. Since the proposed TOSI rules will remove any tax benefit from income splitting through corporations, there appears to be no policy rationale for further penalizing the transferor or lender of the property through subsection 74.4(2). We believe that subsection 74.4(2) should be repealed.

D. Legislative Alternatives

We respectfully submit that there are a number of legislative alternatives to the proposed TOSI and LCGE rules that may achieve some or all of the government's objectives, and that would be easier for taxpayers to apply and the CRA to administer. We are not specifically recommending any of these alternative approaches, but we believe they could be considered if, as we recommend, Finance were to undertake a more comprehensive review of the proposals. As part of that review, Finance also may wish to consider policy considerations underlying income sprinkling, such as the Supreme Court of Canada's reasoning in *Neuman*[15] and the reasons existing tax legislation permit income splitting between spouses and adult children, how other tax regimes in the world address similar concerns and how we can benefit from their experience, and whether it is appropriate and coherent from a policy point of view to continue to allow income splitting for certain types of income (pension income splitting rules, spousal RRSP, etc.).

a) Expand existing TOSI regime to age 24

The existing rules in section 120.4 can be maintained, except that in the definition of "specified individual", the reference to "age of 17" could be modified to "age of 24". The clear advantage of this alternative is that the bright-line tests in the existing TOSI rules are maintained, while income sprinkling for the 18 to 24 age group, which appears to be a significant concern, is eliminated.

To prevent the TOSI from applying to young individuals who are working full time or are *bona fide* young entrepreneurs, the U.S. approach could be considered. Under U.S. rules, a "kiddie tax regime" applies to individuals under the age of 19 and college students under the age of 24. The mechanism used to compute the U.S. "kiddie tax" payable has been discussed briefly under Section B of the submission.

Another alternative that may be more precise in carving out *bona fide* entrepreneurs between ages 18 and 24 might be to exempt those individuals who meet both of the following criteria:

i) The individual is actively engaged on a substantial basis in the activities of the source business,

[15] Melville Neuman v. Her Majesty the Queen, 98 D.T.C. 6297 (S.C.C.).

ii) The source business derives all or substantially all of the income from the provision of services or property to persons or partnerships with which the individual deals at arm's length.

While this may be "rough justice" to some young entrepreneurs, it is preferable to using a reasonableness test that is so difficult to apply in practice to a potentially large group of business owners.

We acknowledge that this approach would not catch income splitting with spouses. However, we believe that there are good arguments, rooted in family law, to support the proposition that contributions made by spouses should be presumed to be equal. Furthermore, unlike the situation with minors and young adults who are full-time students, many spouses have independent sources of income, and accordingly the potential for tax base erosion through splitting with spouses is much less significant.

b) Expanding the income attribution regime

This was discussed in section B of the submission.

c) Limiting the LCGE to one per family unit

Rather than relying on complex rules in proposed subsections 110.6(12) and (12.1) to police eligibility to the LCGE, Finance could consider limiting a family unit's total entitlement to the LCGE in respect of qualified small business corporation shares of an associated group of companies to $835,716 (indexed), and in respect of qualified farm and fishing property under common management, $1,000,000. We would recommend that a family unit for this purpose should be the spouses or common-law partners and dependent children. This would address concerns about multiplication of the LCGE, while at the same time ensuring that where more than one family member is an entrepreneur of a distinct business, multiple capital gains exemptions can be claimed by the family.

d) Valuation day alternative

We recommend consideration be given to a provision which would permit a claim for the LCGE in the taxation year in which the property is disposed of to the extent of the capital gain accrued as of December 31, 2018, based on the fair market value of the property at that date (the latest date for which an election is proposed). This would provide an option for those taxpayers for whom immediate realization of gains by election is not practical. While this will require valuations be undertaken, valuations would also be required if the election is retained. We would be pleased to engage with Finance to discuss the possibility of adding such an option to ensure taxpayers are not inappropriately denied the benefits of the LCGE for gains accrued prior to the coming into force of these amendments.

e) Family unit taxation for all individuals

If the tax regime uses a family unit (spouse or common-law partner, and dependent children) as the taxing unit, this takes away the need or incentive to split income. Such an approach would simplify certain features of the Income Tax Act, and was the recommended approach under the Report of the Carter Commission. While some economists have suggested that family taxation may be out of step with some other jurisdictions around the world, may disproportionately benefit the wealthy and may be an impediment to women entering the workforce, we believe that a properly designed family taxation system could adequately address such concerns. Such a properly designed system would eliminate the "cat-and-mouse" game of income splitting that has been occurring for decades, and could simplify our existing tax legislation. We acknowledge that a change to the family unit as the basic unit of taxation would raise its own issues that would need to be addressed, but nonetheless we believe this is a concept that is worth exploring more systematically.

Appendix A
<u>Illustrative Examples of Proposed TOSI Regime</u>

The attached numerical analysis has been prepared from the perspectives of two provinces, Alberta and Ontario. The results are comparable, and we expect this will be the case across Canada. The analysis was undertaken as follows:

(a) Revisiting the example provided in the Consultation Paper of a household of four adults, three with no income, modified to reflect equal income splitting across all four. We see this as an unlikely situation (in particular, there is no reflection of credits for tuition transferred to the single income earner parent, nor are the students earning any income, even working part-time or from Registered Education Savings Plans), and one which is not reflective of any family's circumstances for a lengthy period. It is therefore excluded from the summary.

(b) Analyzing the consequences for a married couple (no adult children) in various scenarios, as detailed below, under the following assumptions:

(i) The income earner would earn all income as a salary subject to CPP, but not EI, in the absence of planning for income sprinkling. This permits comparison to a single income employee.
(ii) The only personal tax credits are the basic and spousal (where applicable) amounts, CPP and the employment amount.

One Spouse Does Not Contribute

(iii) The income sprinkling is achieved by earning all income through a corporation, accessing the small business deduction, then paying equal dividends to each spouse from the after tax corporate income. EXCEPTION: One couple is assumed to earn $1 million, and the income earner is assumed to receive a salary to avoid high rate corporate taxes and the eligible dividend regime.
(iv) The TOSI rules are applied on the basis that the second spouse makes no contribution of any value.
(v) The additional tax paid due to the TOSI rules (over a single income earner) is computed as a percentage of the tax benefit achieved through perfect income splitting.

One Spouse's Contributions are Over-Valued

(vi) The analysis is then revised to assume that both spouses make meaningful contributions, but the "reasonable" about for one spouse is only 25% of the dividends.
(vii) The tax if income were allocated in this meaningful manner is applied.
(viii) The TOSI rules are applied on the basis the income was not split in this "reasonable manner.
(ix) The additional taxes arising due to the TOSI rules (over a reasonable allocation) is computed as a percentage of the tax benefit achieved through the additional income splitting.

(c) The income levels selected are as follows:
(i) $1 million;
(ii) $500,000;

(iii) $220,000. This was the income level selected in the Consultation Paper. At this income level, earned by one individual, exposes a small amount of income to the new 33% tax bracket;

(iv) $150,000;

(v) $73,000. This is the income level often cited by the Government as the level at or below which 65% of small businesses earn.

We would be pleased to prepare an analysis at another income level at your request.

From this analysis, we observe the following:

(a) There is a cost to every household once TOSI is applied. This arises for two reasons. First, there is under integration which causes the combined corporate and personal tax to be higher than tax on income received directly. Second, to the extent the income would have been taxable at a rate lower than the highest personal tax rate, there is an added tax cost imposed by the use of the TOSI mechanism.

(b) The effective "penalty" on income sprinkling rises as family income falls. In Ontario, the highest income household pays a "penalty" of 6.89% for income sprinkling with a spouse who makes no meaningful contribution. This "penalty" rises sharply for middle and low income households, reaching 866% for the lowest income level analyzed. In Alberta, the result is similar, but more pronounced, with a 26% "penalty" at the highest income level, rising to almost 2,500% at the lowest. We would note that, by contrast, a grossly negligent taxpayer is penalized 50% (which could also be applied to these savings, further exacerbating the cost), and the maximum financial penalty for the criminal offence of tax evasion is 200% of the taxes sought to be evaded.

(c) The effective "penalty" where the less active spouse provides a meaningful contribution is lower than where there is no contribution at the highest and lowest income levels. At the $220,000 and $150,000 income levels, it exceeds the "penalty" for income splitting with a spouse who makes no meaningful contribution.

Application of TOSI Provisions – ALBERTA

Application of TOSI Provisions - ALBERTA
Summary of Example at Various Family Income Levels

Family Income	$ 1,000,000	$ 500,000	$ 220,000	$ 150,000	$ 73,000
One Spouse Does Not Contribute					
Value of Equal Income Split	$ 25,921	$ 24,145	$ 11,738	$ 6,061	$ 467
Cost under TOSI Rules	$ 6,758	$ 8,060	$ 12,964	$ 13,129	$ 11,669
Cost as % of Benefit ("Penalty")	26.07%	33.38%	110.44%	216.62%	2498.67%
One Spouse's Contributions are Overvalued					
Value of Equal Income Split	$ 478	$ 5,211	$ 3,768	$ 1,651	$ 1,731
Cost under TOSI Rules	$ (4)	$ 477	$ 4,942	$ 5,423	$ 3,811
Cost as % of Benefit ("Penalty")	0.00%	9.15%	131.15%	328.48%	220.18%

Application of TOSI Provisions
Family of four earns $220,000
Alberta

	Employee	Business			
		Current Rules	Proposed Rules		
			No Contribution	50% Contribution	
				Reasonable	Unreasonable
Tax Cost					
Corporate Tax (12.5%)	$ -	$ 27,500	$ 27,500	$ 27,500	$ 27,500
Personal Tax:					
Worker	$ 69,318	$ 3,879	$ 3,879	$ 21,881	$ 331
Spouse	$ -	$ 3,879	$ -	$ 331	$ 331
Children	$ -	$ 7,758	$ -	$ 662	$ 662
TOSI	$ -	$ -	$ 59,612	$ -	$ 29,806
Total Taxes	$ 69,318	$ 43,016	$ 90,991	$ 50,374	$ 58,630
Benefit		$ 26,302		$ 7,358	
Cost			$ 21,673	$ 8,256	
Effective Penalty			82.40%	112.21%	

Application of TOSI Provisions
Married Couple earns $1,000,000
Alberta

	Employee	Business			
		Current Rules		Proposed Rules	
			No Contribution	50% Contribution	
				Reasonable	Unreasonable
Tax Cost					
Corporate Tax (12.5%)	$ -	$ 62,500	$ 62,500	$ 62,500	$ 62,500
Personal Tax:					
Worker	$ 442,879	$ 206,493	$ 206,493	$ 296,819	$ 206,493
Spouse	$ -	$ 147,965	$ -	$ 58,117	$ 58,117
TOSI	$ -	$ -	$ 180,644	$ -	$ 90,322
Total Taxes	$ 442,879	$ 416,958	$ 449,637	$ 417,436	$ 417,432
Benefit		$ 25,921		$ 478	
Cost			$ 6,758	$ (4)	
Effective Penalty			26.07%		

Application of TOSI Provisions
Married Couple earns $500,000
Alberta

	Employee	Business			
		Current Rules	Proposed Rules		
			No Contribution	50% Contribution	
				Reasonable	Unreasonable
Tax Cost					
Corporate Tax (12.5%)	$ -	$ 62,500	$ 62,500	$ 62,500	$ 62,500
Personal Tax:					
Worker	$ 202,879	$ 58,117	$ 58,117	$ 102,801	$ 58,117
Spouse	$ -	$ 58,117	$ -	$ 18,644	$ 18,644
TOSI	$ -	$ -	$ 90,322	$ -	$ 45,161
Total Taxes	$ 202,879	$ 178,734	$ 210,939	$ 183,945	$ 184,422
Benefit		$ 24,145		$ 5,211	
Cost			$ 8,060	$ 477	
Effective Penalty			33.38%	9.15%	

Application of TOSI Provisions
Married Couple earns $220,000
Alberta

	Employee	Business			
		Current Rules	Proposed Rules		
			No Contribution	50% Contribution	
				Reasonable	Unreasonable
Tax Cost					
Corporate Tax (12.5%)	$ -	$ 27,500	$ 27,500	$ 27,500	$ 27,500
Personal Tax:					
Worker	$ 69,318	$ 15,040	$ 15,040	$ 29,969	$ 15,040
Spouse	$ -	$ 15,040	$ -	$ 3,879	$ 3,879
TOSI	$ -	$ -	$ 39,742	$ -	$ 19,871
Total Taxes	$ 69,318	$ 57,580	$ 82,282	$ 61,348	$ 66,290
Benefit		$ 11,738		$ 3,768	
Cost			$ 12,964	$ 4,942	
Effective Penalty			110.44%	131.15%	

Application of TOSI Provisions
Married Couple earns $150,000
Alberta

	Employee	Business			
		Current Rules		Proposed Rules	
			No Contribution	50% Contribution	
				Reasonable	Unreasonable
Tax Cost					
Corporate Tax (12.5%)	$ -	$ 18,750	$ 18,750	$ 18,750	$ 18,750
Personal Tax:					
Worker	$ 39,075	$ 7,132	$ 7,132	$ 14,870	$ 7,132
Spouse	$ -	$ 7,132	$ -	$ 1,045	$ 1,045
TOSI	$ -	$ -	$ 26,322	$ -	$ 13,161
Total Taxes	$ 39,075	$ 33,014	$ 52,204	$ 34,665	$ 40,088
Benefit		$ 6,061		$ 1,651	
Cost			$ 13,129	$ 5,423	
Effective Penalty			216.62%	328.48%	

Application of TOSI Provisions
Married Couple earns $73,000
Alberta

	Employee	Business			
		Current Rules		Proposed Rules	
			No Contribution	50% Contribution	
				Reasonable	Unreasonable
Tax Cost					
Corporate Tax (12.5%)	$ -	$ 9,125	$ 9,125	$ 9,125	$ 9,125
Personal Tax:					
Worker	$ 11,694	$ 1,051	$ 1,051	$ 3,833	$ 1,051
Spouse	$ -	$ 1,051	$ -	$ -	$ -
TOSI	$ -	$ -	$ 13,187	$ -	$ 6,593
Total Taxes	$ 11,694	$ 11,227	$ 23,363	$ 12,958	$ 16,769
Benefit		$ 467		$ 1,731	
Cost			$ 11,669	$ 3,811	
Effective Penalty			2498.67%	220.18%	

Application of TOSI Provisions – ONTARIO

Application of TOSI Provisions - ONTARIO
Summary of Example at Various Family Income Levels

Family Income	$ 1,000,000	$ 500,000	$ 220,000	$ 150,000	$ 73,000
One Spouse Does Not Contribute					
Value of Equal Income Split	$ 33,412	$ 32,650	$ 18,723	$ 11,305	$ 1,422
Cost under TOSI Rules	$ 2,303	$ 3,075	$ 10,073	$ 12,263	$ 12,314
Cost as % of Benefit ("Penalty")	6.89%	9.42%	53.80%	108.47%	865.99%
One Spouse's Contributions are Overvalued					
Value of Equal Income Split	$ (1)	$ 5,424	$ 5,160	$ 4,027	$ 1,530
Cost under TOSI Rules	$ (9)	$ (5)	$ 4,661	$ 5,479	$ 5,179
Cost as % of Benefit ("Penalty")	0.00%	0.00%	90.32%	136.07%	338.51%

Application of TOSI Provisions
Family of four earns $220,000
Ontario

	Employee	Business			
		Current Rules		Proposed Rules	
			No Contribution	50% Contribution	
				Reasonable	Unreasonable
Tax Cost					
Corporate Tax (15%)	$ -	$ 33,000	$ 33,000	$ 33,000	$ 33,000
Personal Tax:					
Worker	$ 78,843	$ 2,203	$ 2,203	$ 21,382	$ 2,203
Spouse	$ -	$ 2,203	$ -	$ 300	$ 300
Children	$ -	$ 4,406	$ -	$ 600	$ 600
TOSI	$ -	$ -	$ 63,533	$ -	$ 31,767
Total Taxes	$ 78,843	$ 41,812	$ 98,736	$ 55,282	$ 67,870
Benefit		$ 37,031		$ 13,470	
Cost			$ 19,893	$ 12,588	
Effective Penalty			53.72%	93.45%	

Application of TOSI Provisions
Married Couple earns $1,000,000
Ontario

	Employee	Business — Current Rules	Business — Proposed Rules — No Contribution	Business — Proposed Rules — 50% Contribution — Reasonable	Business — Proposed Rules — 50% Contribution — Unreasonable
Tax Cost					
Corporate Tax (15%)	$ -	$ 75,000	$ 75,000	$ 75,000	$ 75,000
Personal Tax:					
Worker	$ 496,374	$ 231,152	$ 231,152	$ 327,423	$ 231,152
Spouse	$ -	$ 156,810	$ -	$ 60,538	$ 60,538
TOSI	$ -	$ -	$ 192,525	$ -	$ 96,263
Total Taxes	$ 496,374	$ 462,962	$ 498,677	$ 462,961	$ 462,953
Benefit		$ 33,412		$ (1)	
Cost			$ 2,303	$ (9)	
Effective Penalty			6.89%		

Application of TOSI Provisions
Married Couple earns $500,000
Ontario

	Employee	Business			
		Current Rules	Proposed Rules		
			No Contribution	50% Contribution	
				Reasonable	Unreasonable
Tax Cost					
Corporate Tax (15%)	$ -	$ 75,000	$ 75,000	$ 75,000	$ 75,000
Personal Tax:					
Worker	$ 228,726	$ 60,538	$ 60,538	$ 108,674	$ 60,538
Spouse	$ -	$ 60,538	$ -	$ 17,826	$ 17,826
TOSI	$ -	$ -	$ 96,263	$ -	$ 48,131
Total Taxes	$ 228,726	$ 196,076	$ 231,801	$ 201,500	$ 201,495
Benefit		$ 32,650		$ 5,424	
Cost			$ 3,075	$ (5)	
Effective Penalty			9.42%		

Application of TOSI Provisions
Married Couple earns $220,000
Ontario

	Employee	Business			
		Current Rules	Proposed Rules		
			No Contribution	50% Contribution	
				Reasonable	Unreasonable
Tax Cost					
Corporate Tax (15%)	$ -	$ 33,000	$ 33,000	$ 33,000	$ 33,000
Personal Tax:					
Worker	$ 78,843	$ 13,560	$ 13,560	$ 30,077	$ 13,560
Spouse	$ -	$ 13,560	$ -	$ 2,203	$ 2,203
TOSI	$ -	$ -	$ 42,356	$ -	$ 21,178
Total Taxes	$ 78,843	$ 60,120	$ 88,916	$ 65,280	$ 69,941
Benefit		$ 18,723		$ 5,160	
Cost			$ 10,073	$ 4,661	
Effective Penalty			53.80%	90.32%	

Application of TOSI Provisions
Married Couple earns $150,000
Ontario

	Employee	Business – Current Rules	Proposed Rules – No Contribution	Proposed Rules – 50% Contribution – Reasonable	Proposed Rules – 50% Contribution – Unreasonable
Tax Cost					
Corporate Tax (15%)	$ -	$ 22,500	$ 22,500	$ 22,500	$ 22,500
Personal Tax:					
Worker	$ 44,427	$ 5,311	$ 5,311	$ 14,271	$ 5,311
Spouse	$ -	$ 5,311	$ -	$ 378	$ 378
TOSI	$ -	$ -	$ 28,879	$ -	$ 14,439
Total Taxes	$ 44,427	$ 33,122	$ 56,690	$ 37,149	$ 42,628
Benefit		$ 11,305		$ 4,027	
Cost			$ 12,263	$ 5,479	
Effective Penalty			108.47%	136.07%	

Application of TOSI Provisions
Married Couple earns $73,000
Ontario

	Employee	Business			
		Current Rules	Proposed Rules		
			No Contribution	50% Contribution	
				Reasonable	Unreasonable
Tax Cost					
Corporate Tax (15%)	$ -	$ 10,950	$ 10,950	$ 10,950	$ 10,950
Personal Tax:					
Worker	$ 13,008	$ 318	$ 318	$ 2,166	$ 318
Spouse	$ -	$ 318	$ -	$ -	$ -
TOSI	$ -	$ -	$ 14,054	$ -	$ 7,027
Total Taxes	$ 13,008	$ 11,586	$ 25,322	$ 13,116	$ 18,295
Benefit		$ 1,422		$ 1,530	
Cost			$ 12,314	$ 5,179	
Effective Penalty			865.99%	338.51%	

Appendix B

Summary for matrimonial property separation for each Province and Territory

Province	Act and Citation	Section	Text
PEI	Family Law Act, SPEI 1995, c 12	s. 6(1)	When a divorce is granted or a marriage is declared a nullity, or when the spouses are living separate and apart, the spouse whose net family property is the lesser of the two net family properties is entitled to one-half the difference between them.
NB	Marital Property Act, SNB 2012, c 107	3(1)	Each spouse, on application to the Court, is entitled to have the marital property divided in equal shares if
NFLD	Family Law Act, RSNL, c F-2	21(1)	Either spouse is entitled to apply to a court to have the matrimonial assets divided in equal shares, notwithstanding the ownership of these assets, and the court may order that division.
NS	Matrimonial Property Act, RSNS 1989, c 275	12(1)	Either spouse is entitled to apply to the court to have the matrimonial assets divided in equal shares, notwithstanding the ownership of these assets, and the court may order such a division.
NU	Family Law Act, SNWT (Nu), c 18	36(1)	When a divorce is granted or a marriage is declared a nullity, or when the spouses are separated and there is no reasonable prospect that they will resume cohabitation, the spouse whose net family property is the lesser of the two net family properties is entitled to an amount equal to one-half the difference in value between them.
NWT	Family Law Act, SNWT 1997, c 18	36(1)	Same as NU, above.
YK	Family Property and Support Act, RSY 2002, c 83	6(1)	If a marriage breakdown occurs, each spouse is entitled to have the family assets owned at the time of the breakdown by one spouse or both spouses divided in equal shares, despite the ownership of the assets by the spouses as determinable for other purposes.
QC	Civil Code of Québec, CQLR c CCQ-1991	416	In the event of separation from bed and board, or the dissolution or nullity of a marriage, the value of the family patrimony of the spouses, after deducting the

Province	Act and Citation	Section	Text
			debts contracted for the acquisition, improvement, maintenance or preservation of the property composing it, is equally divided between the spouses or between the surviving spouse and the heirs, as the case may be.
ONT	Family Law Act	5	Equalization of net family properties Divorce, etc. **5** (1) When a divorce is granted or a marriage is declared a nullity, or when the spouses are separated and there is no reasonable prospect that they will resume cohabitation, the spouse whose net family property is the lesser of the two net family properties is entitled to one-half the difference between them. R.S.O. 1990, c. F.3, s. 5 (1). (7) The purpose of this section is to recognize that child care, household management and financial provision are the joint responsibilities of the spouses and that inherent in the marital relationship there is equal contribution, whether financial or otherwise, by the spouses to the assumption of these responsibilities, entitling each spouse to the equalization of the net family properties, subject only to the equitable considerations set out in subsection (6). R.S.O. 1990, c. F.3, s. 5 (7).
MN	Family Property Act	13	**Right to accounting and equalization of assets** 13 Each spouse and common-law partner has the right upon application to an accounting and, subject to section 14, an equalization of assets in accordance with this Part.
SASK	Family Property Act	20	PART IV Distribution of Family Property Purpose 20 The purpose of this Act, and in particular of this Part, is to recognize that child care, household management and financial provision are the joint and mutual responsibilities of spouses, and that inherent in the spousal relationship there is joint contribution, whether financial or otherwise, by the spouses to the assumption of these responsibilities that entitles each spouse to an equal distribution of the family property, subject to the exceptions, exemptions and equitable considerations mentioned in this Act.

Province	Act and Citation	Section	Text
AB	Matrimonial Property Act	8	**Matters to be considered** 8 The matters to be taken into consideration in making a distribution under section 7 are the following: (a) the contribution made by each spouse to the marriage and to the welfare of the family, including any contribution made as a homemaker or parent; (b) the contribution, whether financial or in some other form, made by a spouse directly or indirectly to the acquisition, conservation, improvement, operation or management of a business, farm, enterprise or undertaking owned or operated by one or both spouses or by one or both spouses and any other person; (c) the contribution, whether financial or in some other form, made directly or indirectly by or on behalf of a spouse to the acquisition, conservation or improvement of the property; (d) the income, earning capacity, liabilities, obligations, property and other financial resources (i) that each spouse had at the time of marriage, and (ii) that each spouse has at the time of the trial; (e) the duration of the marriage; (f) whether the property was acquired when the spouses were living separate and apart; (g) the terms of an oral or written agreement between the spouses; (h) that a spouse has made (i) a substantial gift of property to a third party, or (ii) a transfer of property to a third party other than a bona fide purchaser for value; (i) a previous distribution of property between the spouses by gift, agreement or matrimonial property order; (j) a prior order made by a court; (k) a tax liability that may be incurred by a spouse as a result of the transfer or sale of property; (l) that a spouse has dissipated property to the detriment of the other spouse; (m) any fact or circumstance that is relevant.