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Department of Finance
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Dear Sirs:

Re: Consultation regarding Morneau's proposals

I am a tax lawyer who has been practising for 36 years, primarily acting for private companies and their shareholders. Over the decades, I have seen hundreds of amendments to the *Income Tax Act* proposed by the Department of Finance. I have never seen proposed amendments cause more discussion, concern and anger than the ones proposed by the Minister of Finance, Bill Morneau, on July 18, 2017.

These proposals will result in a massive tax increase, primarily coming from one amendment to the *Income Tax Act* that has not been discussed in the press. This is the increase in the tax on death. For those individuals who own shares of private companies, the tax payable following their death and that of their spouse increased on July 18 by as much as 20 percentage points, from 26.765% to 45.3% in Ontario. If the Department of Finance does not soften the proposal to eliminate double taxation arising on the death, the increase may be even greater. Given the current wealth of Canadian private companies, this is likely the largest tax increase in the last 35 years.

The proposals will make it more difficult for a family to transition the family business or family farm to the next generation. If the next generation buys the corporation or the family farm corporation from the parents, the next generation will have to use after-tax funds to pay the purchase price. This is unlike an arm's length third party who will be able to use the earnings in the purchased corporation to pay the purchase price.

The proposed amendments will have retroactive effect. Take a doctor, for example, who has accumulated some wealth in a professional corporation, the shares of which are owned by the doctor and his/her spouse. The doctor decided to retire in 2015 at the age of 65. At that time, the doctor knew that the monies in the professional corporation and the income arising therefrom could be paid to both spouses as a dividend, thereby splitting any income between them. That made retirement possible. Starting in 2018, the doctor may no longer income split with his/her spouse even with respect to retained earnings accumulated before July 1, 2017. As a result, retirement is no longer financially feasible.

The proposals will also have a reasonableness test with respect to income sprinkling or income splitting. The reasonableness test will look primarily at labour and financial contribution of family members. The proposals give no credit for the value of the shares currently owned by the family members who do not contribute to the business. So, a non-contributing child who owns shares in the business currently worth $2 million pays tax at the top marginal rate on dividends received after 2017. That should be fixed. If a father and son equally own a corporation and both get paid a salary equal to what an arm's length person would get paid, the father and the son both get taxed at the top rate on dividends received by them and neither are entitled to the lifetime capital gains exemption if they sell the shares of the corporation. That's how the proposed rules are drafted. That should also be fixed.

So, how do we move forward in a sensible manner? Here's what I would do:

1. It does not make sense that an owner of a private company pays tax at one rate and his/her spouse who is a shareholder in the family business may have to pay tax at the top marginal rate. Both spouses should be taxed in the same way. Let's not call it income sprinkling or income splitting. Instead, let's just say the family owns a business and both spouses own shares in their company. If that provides the family with the ability to income split, so be it. Consider permitting other Canadians to split income with their spouse to some degree. Income splitting between spouses is already permitted to the approximately 30% of Canadians who hold a pension.

As well, certain professions such as lawyers and accountants are not permitted to have spouses or family members as shareholders unless they are also licensees. Doctors and dentists have the right to income split with family members. Take that right away from all professions other than doctors. Allow doctors to income split with their spouses if their professional corporation earns less than a certain amount in a year. This will give lower income doctors a benefit and will particularly allow doctors to continue working in remote areas where often their spouses can't work.

2. What to do about other family members who are shareholders? Provide that anyone can be a shareholder in your company and pay tax at their marginal rates if he or she has worked for at least two years full-time for the company. Other family members can be taxed at the top rate unless they have made a meaningful contribution. This will make the rules easier to understand and straightforward for the Canada Revenue Agency to administer.

3. The proposed rules on the multiplication of the capital gains exemption are too complicated. These rules should only permit both spouses and any family members working full-time in the business at the time of sale to benefit from the exemption. Again, this will make the rules simple to understand and easy for the Canada Revenue Agency to apply.

4. Allow a person to sell his/her shares of a corporation or family farm corporation to a family member or to the family member's corporation provided the purchaser has worked full-time in the business for at least two years before the purchase and one year after the purchase. This will permit succession planning without the new rules that restrict the conversion of dividend income into capital gains from applying.

5. Before imposing an additional punitive tax on private company investment income, the Department of Finance has to consider how all companies are taxed on investment income arising from retained earnings not utilized in the business. Currently, investment income earned by public companies is taxed at 26.5% in Ontario. Canadian-controlled private companies pay tax at 50.17% in Ontario and receive a partial tax refund when dividends are distributed. Based on materials presented at the Canadian Tax Foundation Conference on September 24, 2017, most of the benefit to accumulating retained earnings in a company arises with respect to income taxed at the small business rate. To even the playing field, consider eliminating the small business deduction for any Canadian private company that earns more than a certain

amount of non-active income in a year. Also, consider increasing the tax on investment income earned by public companies by a modest amount.

If the proposed tax on investment income becomes law, private companies will stop making risky investments, which will greatly reduce the tax revenue generated. Why would a private company invest in a risky venture where a sizable portion of any gain has to be paid to the Canada Revenue Agency?

6. The Department of Finance must rethink the rules that produce a tax liability when a taxpayer dies. Dying is not a matter of choice and taxes are accelerated as a result of death. This is a penalty tax on death. No asset is being sold by the deceased and yet tax is payable. This is generally a hardship on the family. Paying tax at capital gains rate on death should suffice. The pipeline strategy should remain in place. And if the proposed tax changes remain in place, to almost double the tax on death without any grandfathering is incredibly unfair. And to apply a double tax on families where parents pass away is cruel. As well, many taxpayers have made plans to fund the tax on death by buying life insurance. Many may now be unable to buy additional life insurance since they may no longer be insurable.

7. Finally, I am sure that when the Liberals raised the top marginal rate for individuals to 53.53% in Ontario, they thought they would collect more tax revenue from the wealthy. I suspect that this did not happen. Studies have shown that increasing the tax rate over 50% does not generate any additional revenue. Lower the top rate and the number of corporations will decrease without collecting a nickel less of tax dollars.

Yours truly,

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