CC&C Professional Corporation
CHARTERED PROFESSIONAL ACCOUNTANTS

Federal Tax Memo
Update on Changes to December 14, 2017

Where do we now stand on Version 2 of the Canadian Private Corporation Tax Proposals?

There has been a ridiculous amount of confusion in the press and from various federal government officials as to the changes from July 18 through to October 22 and now to December 14 when the latest changes to income sprinkling and the TOSI (Tax on Split Income) will shake down to actual tax law changes. The 2018 Federal Budget (March 2018) will make the process even more difficult to understand and plan to minimize tax small business burdens for 2018 and forward.

Updated Review of October 2017 Changes

Changes to limit access to the lifetime capital gain exemption:

On October 16, 2017, the government said that they **are no longer moving forward** with measures that limit access to the lifetime capital gain exemption. While this is welcome news for businesses and their advisors the real issues are in the details. For instance, it is uncertain whether the announcement meant that the entire proposed draft legislation dealing with the lifetime capital gain exemption is abandoned, or if certain aspects of it (such as the "unreasonable" amount of taxable capital gains realized by a "specified individual" being ineligible for the exemption) may be retained.Your history of use of the LCGE is still important and must be reviewed as part of any planning in this area is started.

Proposals to prevent surplus stripping – proposed amendment to section 84.1 and proposed section 246.1*:*

Therefore, it was very good news when the government **said on October 19, 2017 that they are no longer moving forward with measures relating to the conversion of income into capital gains,** which, presumably refers to the proposed amendments to section 84.1 and proposed section 246.1. It remains to be seen whether the proposed amendments to subsections in 120.4 will also be abandoned. If the government goes ahead with the amendments to subsections 120.4(4) or (5), non-active family members disposing of private corporation shares on a non-arm's length basis (including deemed dispositions at death) would still not be able to access capital gains treatment or the lifetime capital gains exemption. We believe that such a result would be inconsistent with the government's announcement on October 19, 2017 and therefore we will look closely for this when draft legislation is eventually released.

Proposed reduction of the small business tax rate:

The previous Federal government enacted scheduled reductions to the federal corporate small business income tax rate (applicable only to the first $500,000 of active business income) to an eventual 9% rate by 2019. However, the scheduled reduction was cancelled by the current government as part of their 2016 budget and as a result, the federal small business rate has remained at 10.5%. Along with the announcements that the government is pushing ahead with tax changes regarding income sprinkling and corporate passive income, **the current Liberal government announced that they will reinstate the previous government's scheduled rate reductions as follows: 10% effective fiscal period started after January 1, 2018 and 9% effective January 1, 2019.** For non December 31 fiscal years the rate reductions will be prorated.

We have no doubt the small business tax rate reductions were brought back to the table as a sweetener to the confusing and costly details of the July 18, 2017 tax proposals.

This rate reduction is generally seen as a good thing in tax law but there are dividend and distribution complications that are seen as creating more complexity in the future. For some the $5,000 tax saving is a benefit that we will enjoy immediately and as accountants it will help explain the increase in our accounting fees to our clients because of the increased complexity with filing compliance under the new laws.

Major Changes as of December 14, 2017 Updates

On December 13, 2017, the tax and business community finally got the chance to review version two of the tax on split income ("TOSI") or the so-called "income sprinkling" proposals. The Department of Finance announced in July 2018 that these revised proposals would be released later this past Fall. Here we are a week away from winter and they have given us a blast of cold frigid tax rules.

The rules are very complex and require tax specialist advice to apply to your specific situation.

Yes, major overhaul has been done to remove some of the confusing issues of the originally proposed TOSI rules. However, the fact that a "reasonableness" test and substantial complexity still exists is brutally confusing due to the uncertainty and difficulty they will create for taxpayers in applying the rules and the Canada Revenue Agency (CRA) and the Courts enforcing them after test cases start to flow from reassessments.

Where the proposals from July 18 seriously convoluted the definition of a "specified individual" by including reference and connection to income from the business, the version from December 13 simplified and broadened the definition to generally include any adult individual who is a resident in Canada, or any minor whose parent is a resident in Canada.

The TOSI rules apply the highest marginal rates (Ontario at 53.53%) to "split income" received by a "specified individual" that is not an "excluded amount".

December 13, 2017 changes to the definition of "specified individual"

Where the proposals from July 18 seriously convoluted the definition of a "specified individual" by including reference and connection to income from the business, the version from December 13 simplified and broadened the definition to generally include any adult individual who is a resident in Canada, or any minor whose parent is a resident in Canada

December 13 changes to the definition of "split income"

Under the July 18 proposed TOSI rules, the definition of split income was expanded to include income from indebtedness, income or capital gains from the disposition of property, income from a conferred benefit and secondary income earned on income previously subject to the attribution rules or TOSI rules. The December 13 proposed legislation has taken a middle ground approach by retaining the indebtedness income and income or capital gains from the disposition of property, while dropping the latter two additions from July 18.

December 13 changes to the definition of "excluded income".

The definition of "excluded amount" has been greatly expanded from the July18 version to include income resulting from:

• Property transferred in respect of a separation agreement in the context of a breakdown of a marriage or common-law partnership;

• A taxable capital gain that results on the deemed disposition as a result of the death of a taxpayer; and

• A taxable capital gain from the disposition of qualified farm or fishing property or qualified small business corporation shares;

These additions are certainly welcomed, and, particularly the expansion to relationship breakdown and death, are necessary to prevent unfair tax results arising from dispositions that are entirely involuntary.

The previous references in the July 18 version to "split portion" and the reasonableness test contained therein has been removed. Instead, analogous concepts have been imported into the "excluded amount" definition directly through a number of new defined terms: "excluded business," "excluded shares," "safe harbor capital return" and "reasonable return." The easiest way to explain how the "excluded amount" definition applies in practice is to break the rules down as to how they apply to each of the following four age categories:

Under age 18

Any income described in the definition of split income received by a minor (unless from certain inherited property) is subject to the TOSI (53.5%). The existing kiddie tax rules remain with virtually no changes, other than the inclusion of indebtedness income and income or capital gains from the disposition of property as described above.

Age 18 to 24

Income described in the definition of split income received by an individual that has reached the age of 17 but not the age of 24 before the year is subject to the TOSI rules unless the amount received is considered to fall into one of five exclusions.

Firstly, there is an exception of certain inherited properties similar to minors. Secondly, if the income in question is not derived directly or indirectly from a "related business," it is not subject to the TOSI rules. For example, Mr. A owns and operates a corporation and the corporation declares and pays a dividend to his 18-year-old daughter. Because of Mr. A's relation to his daughter, the dividend income is considered to be from a "related business" and would be subject to the TOSI rules unless it falls into another exclusion. Alternatively, if Mr. A's daughter receives dividends from a corporation in which no related person is actively engaged or is a 10 per cent (or more) owner, she would not be deriving income from a "related business" and TOSI should not apply to her. The July 18 proposal extended the meaning of related persons to uncles, aunts, nieces and nephews—this change has been abandoned in the December 13 proposal.

Thirdly, income derived directly or indirectly from an "excluded business" is excluded from the TOSI rules application. An "excluded business" is considered to include a business in which the individual is actively engaged on a regular, continuous and substantial basis in either the taxation year in question, or any five historical years. Whether an individual meets this actively engaged threshold appears to be a factual test, but in an attempt at a bright-line test, the government enacted a deeming rule whereby one is deemed to have met the actively engaged threshold by working in the business at least an average of 20 hours per week during the portion of the year in which the business is operational.

Certainly, it will be ideal to be able to rely on the 20-hour test rather than trying to substantiate that one has engaged on a regular, continuous and substantial basis, but this will presumably require increased efforts in the form of record keeping tracking hours worked (timesheets for everyone! Yay!) Perhaps the most interesting aspect of the "excluded business" rule is that once an individual has met the actively engaged test for five years, which do not need to be consecutive, then the individual (and anyone inheriting the individual's interest) will forever be protected by the "excluded business" exclusion.

This is probably what the government meant when they touted that someone who made a "meaningful contribution" will not be subject to TOSI

Therefore, if Mr. A's daughter averaged at least 20 hours per week of work in the business operated by Mr. A's corporation from 2014 through 2018, Mr. A can pay his daughter any amount of dividend every year starting from 2014 and for the entire lifetime of the daughter without TOSI applying to the daughter (to the extent she is 18 or over in 2014).[1]

If the individual between age 18 to 24 derives income from a "related business" and has not worked for a sufficient amount of time in the business to qualify under the "excluded business," the individual could potentially still qualify for the "safe harbour capital return" exclusion to minimize or potentially eliminate the amount of income subject to TOSI. This exclusion reduces the income includable in TOSI by a notional amount calculated by the prescribed rate of interest multiplied by the fair market value ("FMV") of property contributed by the individual in support of the related business. It is important to note that the computation of safe harbour capital return does not require a carve-out of capital obtained from a non-arm's length source, but the prescribed rate of interest is a low rate (currently 1%). Therefore, if Mr. A's daughter (between age 18 to 24) has contributed $100,000 to Mr. A's corporation either as debt or equity and Mr. A's daughter does not work in the business, she will be allowed $1,000 of income per year before TOSI starts applying, under the current prescribed rate of interest.

If the individual between age 18 to 24 derives income from a "related business," has not worked sufficient amount to qualify under "excluded business," and is earning more income than the "safe harbour capital return," the individual could still reduce or potentially eliminate TOSI income using the fifth and final exclusion: the "reasonable return" exclusion. This exclusion is a resurrection of the July 18 reasonableness test, but for individuals in this age group, the reasonableness test is to be applied having regard only to contribution of "arm's length capital" by the individual. The December 13 version of the reasonableness test refers to the following factors, assessed based on relative contributions of the individual and each related person:

• The work performed by the individual;

• The property contributed directly or indirectly by the individual (but, as stated above, could only consider "arms length capital" for this age group);

• The risks assumed by the individual in respect of the business;

• The total amounts already paid to or for the benefit of the individual in respect of the business; and

• Any other factors that may be relevant.

There are a number of interesting observations to be made from this. Like the July 18 version of the proposed rule, there is uncertainty whether historical contribution of work / property contributed / risk assumed can be considered in the reasonableness test. It is possible to interpret the provision to mean that one can only look at current year contributions. On the other hand, practical challenges abound if a business owner needs to tally all historical amounts already paid to him or her since inception of the business in order to arrive at what is reasonable in the current year. It is disappointing that the government did not take the opportunity to clarify this in the legislation.

An interesting addition to the test is the "any other facts that may be relevant." This could be used to address situations where profits are not tied directly to work / property contributed / risk assumed, e.g. windfall gains. On the flip side, this could be used by the CRA to reduce the reasonable amount an individual is otherwise entitled to if it feels there are "other factors" present that justify such a reduction. Time will tell how this discretion will be applied.

Perhaps the most interesting, though, is that this revised reasonableness test no longer refers to an arm's length standard. Instead, the test focuses on the relative contribution of each related persons. Of course, it is still a subjective and potentially difficult exercise to measure and compare the contribution of each person to a business, but at least there appears to no longer be a requirement to benchmark a business owner's return

against an arm's length standard which the July 18 version would have required.

Age 25 and over

The rules are less stringent for individuals who have attained the age of 24 before the year. Just like the 18 to 24 age group, an individual who has attained age 24 before the year will not be subject to TOSI if the income is not derived directly or indirectly from a "related business" or if the income is derived from an "excluded business." In addition to this, individuals in this age group will not be subject to TOSI on income from "excluded shares."

"Excluded shares" are defined to mean shares of a corporation owned by the individual where:

• Less than 90% of its "business income" for the last tax year that ends at or before that time was from the provision of services;

• The corporation is not a professional corporation;

• Immediately before that time, the individual owns shares representing at least 10% of the votes and FMV of the corporation;

• All or substantially all of the income of the corporation's income for the last tax year that ends at or before that time is not derived directly or indirectly from another related business, e.g. collecting rent from a related business.

At first glance the "excluded shares" exclusion appears to be a generous exclusion for adult individuals who are not professionals and who own 10% or more of a corporation, allowing them unlimited opportunity to income split. Many typical private corporations are held 50/50 by spouses or common-law partners, thus each shareholder would hold more than 10% of votes and value. However, there are a number of potential issues that could arise that make this "excluded shares" exclusion to become unavailable. We will discuss some of these issues in more detail below.

When an individual in this age group does not meet any of the exclusions discussed, the individual could still qualify for the "reasonable return" exclusion based on the work performed / property contributed / risks assumed / historical payments factors discussed earlier for individuals between 18 to 24 years of

age. The difference is that individuals over 24 will not be required to exclude property that is not "arm's length capital."

Individual with a spouse who is 65 and up

In an attempt to align with the existing pension income-splitting rules, the TOSI rules will not apply to income received by an individual from a related business if the individual's spouse or common-law partner has attained the age of 64 before the year and the amount would have been an excluded amount were it to be included in her or his income. In other words, income splitting from a private business will generally be allowed starting in the year a contributing spouse turns 65.

TOSI Rules on Capital Gains

Subsections 120.4(4) and (5) are currently in place to recharacterize an otherwise capital gain into a dividend under certain non-arm's length dispositions. The July 18 proposals expanded the application from minor shareholders to also include adults, resulting in very adverse tax consequences in many unexpected situations. In the latest version, subsections(4) and (5) has been narrowed back to only being applicable to minors. The business and tax community can breathe a collective sigh of relief at least on this front.

Under the December 13 proposal, TOSI will not apply to capital gain on disposition of qualified farm or fishing property (QFP) or qualified small business corporation (QSBC) shares, regardless of the age of the holder or whether the lifetime capital gain exemption (LCGE) is claimed. This means that capital gain splitting with non-active family members and multiplication of the LCGE will still be allowed for shares and property that qualify. Capital gains on shares or property that do not qualify will be subject to the same TOSI rules and exclusions described earlier. Regularly purifying private corporations to maintain QSBC share status will likely be a more prominent tax planning strategy going forward as a result.

Effective Date

Proposed rules still apply for 2018 and subsequent years, i.e. 2017 is the last year under the current TOSI rules. However, it is worth noting that for taxpayers seeking to rely on the "excluded shares" exclusion, they will have until the end of 2018 to meet the condition of owning at least 10% of the outstanding shares of a corporation in terms of votes and value. Notwithstanding, it is disappointing that the Government did not delay the application of these proposals to January 1, 2019. The proposals are very complex and it will certainly take the tax and business community quite some time to digest and properly apply. Affected taxpayers deserve more time to appropriately understand and properly plan their affairs.

Problems with the "Excluded Shares" Exclusion

Carve-out for professional corporation and service businesses

It's no surprise that the government would deny the benefit of the "excluded shares" exclusion to professional corporations given its rhetoric over the last two years against professionals, especially doctors. A professional whose spouse or common-law partner also owns shares in the professional corporation will not be able to rely on this exclusion to income split, because of the explicit carve-out of professional corporation in the definition of "excluded shares." The spouse or common-law partner will have to rely on other exclusions, such as working over 20 hours per week in order to qualify for the "excluded business" exception.

What is surprising is that the government is denying this exclusion to any and all businesses who derive their income from the provision of services. The policy rationale behind this is presumably that the government does not want businesses that are 'professional-like' to be able to enjoy the exclusion.

However, to discriminate against all service business in one broad stroke is analogous to shooting mice with an elephant gun, especially given that a large majority of Canadian businesses are service-oriented.[2] For example, a couple who starts a hair salon as 50/50

shareholders will not be able to income split if one spouse does not contribute to the business; whereas another couple who starts a hotdog stand as 50/50 shareholders will be able to income split regardless of contribution. Both businesses could have similar capital requirements and risk profile, but the tax treatment is vastly different simply because one couple went into the service industry and the other decides to sell products.

This also affects large family-owned service businesses, such as construction service companies, oilfield services companies, etc. We believe this is a very unfair approach that unnecessarily punishes the majority of privately-owned businesses, and we believe that proper enforcement of the current personal services business rules would have been sufficient to address most of the government's concerns.

All or substantially all of the income not derived from another   related business

Another part of the definition of "excluded shares" that appears problematic is the requirement that all or substantially all of the income of the corporation not be derived directly or indirectly from another related business. Assume a typical Holdco-Opco structure where Holdco shares are owned 50/50 by husband and wife. Opco's business would be a related business to both husband and wife because each them indirectly owns 10% or more of Opco. This would mean that Holdco shares can probably never be "excluded shares" because its income is indeed derived directly or indirectly from another "related business." Hopefully this is an unintended technical glitch because we see no policy rationale as to why a private business owner should be punished simply because a multi-tier holding structure is chosen, which often is done for important business reasons. However, what is the likelihood of the government fixing this glitch retroactively effective January 1, 2018? One would hope so since the one year transitional period for "excluded shares" only apply in respect of the 10% holding requirement.

What is business income?

One more aspect of the "excluded shares" exclusion that is sure to result in uncertainty and controversy is that one of its key conditions is based on the concept of "business income." "Business income" is not a term that has been used elsewhere in the Act. On the one hand, there has always been a distinction between income from property and income from business, 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. On the other hand, a "business" is broadly defined in subsection 248(1), and includes an "undertaking of any kind whatever."

So, what is "business income?" This will be an important distinction, for example, for a holding corporation whose sole activity is to make investments. Is the income from such investments "business income" or not? If not, the shares of the corporation could

potentially be "excluded shares" for any family shareholder owning 10% or more, thus allowing income splitting regardless of contribution.

Is the new "Excluded Shares" Definition a Disguised Attack on Family Trusts?

The requirement of 10% votes and value explicitly refers to shares that are owned by an individual. A common holding structure for private corporations is to hold the shares in family trusts. When the private corporation pays a dividend to the family trust, the trust often distributes that dividend to a beneficiary of the trust. Similarly, if the family trust disposes of the shares of the private corporation, the trust may distribute the taxable capital gain to a beneficiary. Although subsections 104 (19), (21) and (21.2) of the Act allow the trust to make designations to deem a beneficiary to have received the respective dividend or taxable capital gain, and even deem the beneficiary to have disposed of the shares in question, the Act does not deem the beneficiary to hold or own the private corporation shares held by the trust. Because of this, it is possible that beneficiaries of a family trust would never be able to rely on the "excluded shares" exclusion for dividends or taxable capital gains allocated from a trust. Is this an intentional result by the government? It may be possible.

Recall that the July 18 proposal denied the claiming of LCGE of any property held in trust but the government announced in October 2017 that they had abandoned those proposals. This is perhaps an alternative way to curb income and capital gain splitting through trusts. Nevertheless, even if the "excluded shares" exclusion is unavailable, an individual disposing of properties that are not QSBC or QFP property could still potentially avoid TOSI by meeting the "excluded business" or "reasonable return" exclusions with sufficient contributions.

Concluding Comments

The ability for the average business person to understand these rules verges on the impossible. All we have done here is only a preliminary overview of the December 13,2017 TOSI proposals. There are likely many more issues and technical glitches in the legislation that tax experts will discover. By the government's own account, these TOSI measures will generate approximately $200 million of additional tax revenue per year, a drop in the bucket for the government's budget. Yet, the administrative and documentation burden for Canadian private businesses will be enormous, particularly when coupled with the corporate passive income proposal that the government is committed to introducing.

Over the past two years the changes to the small business deduction (Specified Business Income), ITA 55(2) changes and work in progress rule changes have combined to inject a huge complex burden for small businesses ibn Canada

Finally, as has been common with our existing government, a gender-based analysis commentary is included as part of the TOSI proposals:

Data show that men represent over 70% of higher-income earners initiating income sprinkling strategies, and women represent about 68% of recipients of sprinkled dividends (and 58% of recipients of income derived from trust and partnerships). While this income is of benefit for recipients, it also creates incentives that reduce female participation in the workforce. Increased participation of women in the workforce is a source of economic opportunity for individuals and is a major driver of overall economic growth.

We had to read the above twice to make sure the government was serious when they produced such commentary. Really? This statement is shocking especially to members of our firm who have children and stay-at-home spouses. Without exception, the decision for members of our firm who have stay-at-home spouses was made for the betterment of the family as a whole with tax impacts not at all being part of the analysis for the resulting decision. To suggest that the income-sprinkling proposals will contribute to incentives for stay-at-home females to enter the workforce is nonsensical and offensive (notwithstanding that the authors are not economists and have not studied gender-based issues but instead rely on real life and common sense).

Unlike the other parts of the July 18, 2017, the proposal for corporate passive income was in the form of a consultation paper not by actual draft legislation. A summary of what was proposed was to render the refundable dividend tax on hand (RDTOH) account of Canadian controlled private corporations (CCPC) no longer refundable and to cause the non-taxable portion of capital gains to no longer be includable in the capital dividend account (CDA). Effectively, a 50% permanent upfront corporate tax (rate depending on the province) would be imposed on passive income realized by a CCPC.

In comparison, under the current rules 30% of the 50% upfront tax on passive income is refundable upon eventual distribution. Adding the proposed 50% permanent corporate tax to personal tax applicable on eventual distribution, the effective tax rate on corporate passive income could exceed 70%. In theory, this regime should cause the ultimate return on corporate passive investment to be equal to the return of an employee investing her or his after-tax earnings. However, due to unfair tax integration of the tax system in most provinces and the 50% upfront corporate tax being a flat tax irrespective of income level, the impact of the proposal could actually leave owners of private corporations significantly worse off than an employee with respect to passive investments, particularly where the investment is funded by general corporate rate income.

It was very disappointing news when the government said on October 18, 2017 that they will not change the original proposal and in fact release draft legislation as part of federal 2018 budget, with a vague promise to tweak the rules to soften the impact, as follows:

- All "past investments" and the income earned from those investments will be protected;
- A starting threshold of $50,000 of passive income per year, for which "there will be no tax increase;" and
- The government states that they will work with the venture capital and angel investment sectors so that the changes will not negatively impact them.

As a planning step if your private company has investments of about $1,000,000. You should consider separating the corporate ownership of active business and passive business assets.

The assurance of grandfathering relief is of course comforting to taxpayers with significant assets already accumulated inside private corporations, but again, the facts are in the details. For instance, we do not know what exactly will be grandfathered. It could be an inventory of existing corporate passive investment, or some kind of measure based on, say, retained earnings to date or current fair market value of all corporate assets. And grandfathering based on what date? July 18, 2017, October 18, 2017 or upon the release of draft legislation in 2018? Also, how exactly will grandfathered assets be tracked, given assets can be disposed of and cash is fungible, or will grandfathering simply be lost when a grandfathered asset is disposed of?

Presumably, rules will be required to cause grandfathering to cease when ownership of the corporation changes hands. Such details and questions aside, ultimately the grandfathering regime will have to strike a fine balance between protecting corporate assets accumulated prior to these changes, and the inherent unfairness of allowing one population of corporate investors preferential tax treatment (a 30% rate advantage, presumably throughout the lifetime of the corporate owner) that is not accessible to the rest of country.

The threshold of $50,000 of passive income per year is declared by the government as the solution to ensure that the proposed 50% upfront permanent tax will apply only to the wealthiest of corporations. Many speculated that this $50,000 threshold will be implemented through an annual allowable maximum on additions to the RDTOH. Setting aside the debate whether $50,000 is the right number, there are still many unanswered questions regarding this *de minimis* rule. For example, how will this be applied with respect to capital gains, which by nature, will be "variable", i.e. appreciation is accrued each year until being realized as a large lump sum eventually, and what portion of the non-taxable portion of such capital gain can be added to non taxable CDA? What if the capital gain is on the disposition of a business asset, for example, the real estate in which the active business is carried on? It does not appear to be consistent with the government's message of encouraging business investments if such gains will be caught by these punitive rules.

Extremely complicated anti-avoidance rules will surely be needed to prevent taxpayers from multiplying the $50,000 threshold through the use of multiple corporations. As well, clear legislation will be needed to provide clarity on what constitutes passive income. The vagueness of the current history and legislative regime and tax case law on the matter of property income versus business income may be passable for an upfront tax that is refundable, but it certainly will not be acceptable when the differentiation leads to a 30% permanent rate differential. Also, as the government has indicated, the regime will need to be configured to accommodate corporate venture capital and angel investors, for whom the $50,000 per year limit will not be workable, and whatever rules arising from this will certainly be complicated.

All these complications will be on top of the complexity described in the July 18, 2017 consultation paper and will require the tracking of additional numerous pools of income. For example, under the proposed apportionment method described in the consultation paper, passive income will be proportionately assigned to either a general rate income pool, small business rate income pool, and a shareholder's after-tax income pool but with the October 19, 2017 announcement, there will be even more pools that will have to be tracked. We have no doubt that the legislation needed to implement these corporate passive income rules will be extremely complex – perhaps the most complex we have seen in our collective careers in tax. While such complexity is fascinating to tax geeks, it will not be good for business. Since July 18, 2017, the prospect of the new corporate passive income regime has had a drastic chilling effect on private capital markets and the October 14, 2017 announcement, with its lack of details, has alleviated little of the concerns.

Despite the fairy tales that these proposals will unlock corporate "dead money," we think that the government is trying to justify a one time tax grab. It should be obvious that passive investments are not "dead money" unless it is bundle of cash hidden underneath a rock in the backyard. Even money that is deposited in banks would be immediately deployed in the economy as loans and therefore such "dead money" statements are complete nonsense made for pure political gain!

The corporate passive income proposals should be dropped completely in order to bring back certainty and prevent economic damage that has already and will continue to occur. It will certainly make the fee income for tax professional go up and the political future of the Liberals go down!

Proposal on income sprinkling:

The number of times the phrase "income sprinkling "has been printed has represented the bulk of the articles on the draft legislation released on July 18, 2017. A simplification of the proposals is that, the draft rules expand the existing "kiddie tax" regime to adults so that private business income beyond a "reasonable" amount received by certain related adults is automatically subject to top marginal tax rates and loses sheltering of personal tax credits.

The proposed regime has been heavily criticized due to its broadness, complexity and the fact that it ignores the indirect contribution and risks assumed by family members of a business owner (especially spouses).It is almost humorous that our Prime Minister's attempts at equalizing rights between the opposite sexes is counter to this change in tax law to shareholder spouses of family businesses.

As part of the October 16, 2017 announcement, the government stated that they will move forward with the income sprinkling proposals but will work to reduce the compliance burden with respect to establishing the contributions of spouses and family members. While this is certainly a disappointing development, there may be silver linings if you study the details.

In the version of the rules contained in the July 18, 2017 draft legislation, top marginal tax rates automatically apply to certain income or capital gains received by an individual if the amount exceeds what would have been paid by an arm's-length entity, having regard to functions performed, assets contributed, risks assumed by the individual as well as all historical payments to the individual. The draft legislation was not clear on whether historical contributions could be taken into account, and the requirement to consider historical payments was particularly difficult because of its retroactive effect and the administrative burden of compiling such information. The October 16, 2017 announcement appears to clarify that the final version of the rules will take into account past contributions by an individual (which will be helpful to retired business owners who still own an interest in the business). The announcement also omitted the historical payments factor. Whether this omission is intentional or not remains to be seen, but we could be left with three factors to consider for the reasonableness test: functions, assets and risks. If so, this would make the rules easier to apply. Another interesting observation is that the term "*labour contributions*" instead of "*functions … performed,*" was used and that may be another attempt to simplify the rules.

The lack of mention of an "arm's-length" standard in the announcement, combined with the statement that impacted business owners will be "*asked to demonstrate their contribution through any combination [of functions performed/assets contributed /risks assumed]"* suggests that the government may be contemplating some sort of bright-line test whereby a business owner who has made a certain minimum threshold of contribution of functions, assets and/or risks assumed will not be capped to any maximum allowable income or capital gain. If that is the case, it would be a significant improvement to the July 18, 2017 version, and will result in a lot more certainty and reduced compliance burden for business owners going forward.

Notwithstanding, the fact that taxpayers and advisors like us have to "read between the lines" of press releases to guess what the government is proposing is, to put it mildly, unsettling. At least the government appears to be heading into a more reasonable direction, but there is no certainty until the next Federal Budget legislation is released.

Where are we with private company taxation?

The tax advisor community has proclaimed over and over again that Canada is due for a comprehensive tax reform. As a new CA in 1974 my timing was fortunate to study the "new 1972 tax rules" that included the taxation of capital gains and the integration of private company and individual taxation. That was 43 years ago and Canada has changed and at some point a complete gutting and renovation of our tax system will be required. The tax rules have been patched and rejigged to the point that compliance is a nightmare and too expensive for small business owners. **In the meantime, we await further direction from the government regarding the passive income proposals and the next round of draft legislation to address the income sprinkling proposals.** Hopefully the experience of the last 149 days – from July 18, 2017 to date – have taught our political leaders that there is a better way for the Queen to collect her ransom to run the ship of state?

These rules are so complicated we have spent at least five PD tax days since mid October 2017 reviewing them and after the March 2018 Federal Budget they may be modified again.

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