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Closing Tax Planning Opportunities for Private Corporations in Canada: What is the Impact on the Medical Profession?

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ABSTRACT

The federal government has recently proposed significant changes to the taxation of private corporations in Canada. These changes will significantly affect, in particular, medical doctors as many of them use private corporations for tax and financial planning purposes. This paper focuses specifically on how the proposed tax changes will affect medical doctors, not just because of their importance to society, but also because of their unique financial situation.

Following the federal government's release of its initial reform proposal, many doctors were upset that they were labeled as tax cheats who did not "pay their fair share". It was predicted that these reforms would have resulted in a significant negative impact on the healthcare system. The government, however, amended the tax proposals to reduce the adverse affects on medical doctors and they now appear somewhat placated. Only time will tell the ultimate impact of private corporation tax reform on the medical profession and the consequences to health care in this country.

Key Words: taxation reform, Canadian Controlled Private Corporations, medical doctors, healthcare system, income sprinkling, passive investment

ABBREVIATIONS

CCPC -	Canadian Controlled Private Corporation
CMA -	Canadian Medical Association
COD-	Concerned Ontario Doctors
CRA -	Canadian Revenue Agency
GAAR -	General Anti-Avoidance Rule
ITA -	Income Tax Act
LCGE -	Lifetime Capital Gains Exemption
NBMS -	New Brunswick Medical Society
OBCA -	Business Corporations Act (Ontario)
TOSI -	Tax on Split Income

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INTRODUCTION

Over the past year, the federal government proposed and implemented changes to the taxation of private corporations as they believed that “some may be using corporate structures to avoid paying their fair share, rather than to invest in their business and maintain their competitive advantage.”¹ One group of professionals that has recently begun to make widespread use of private corporations is medical doctors. As they are not employees of the state, but rather private contractors, they have been able to use the existing tax rules applicable generally to private corporations and their shareholders. Medical doctors have been at the centre of the political debate surrounding the taxation of private corporations.

This paper will examine the nature and creation of Canadian Controlled Private Corporations (CCPCs) in Canada, including what benefits they bestow. As doctors operate through professional corporations, this essay will focus specifically on the incorporation of professionals. Subsequently, this paper will analyze who are the beneficiaries of private corporations, by both industry and by income level. It will then discuss why the taxation of medical doctors is substantially different than other professionals that utilize CCPCs.

As previously stated, the government is concerned that the current taxation system is not fair and confers advantages on specific groups of people. The Consultation Paper released in July 2017 contained reforms that aimed to rectify this perceived lack of fairness. This

¹ Department of Finance Canada, *Tax Planning Using Private Corporations* (Ottawa: Department of Finance Canada, 2017), at 1[Tax Planning Using Private Corporations].

paper will examine the rationale for these changes along with discussing the actual reforms themselves. The main reforms the government would like to make regarding taxing private corporations are a) limiting the use of income sprinkling, b) preventing passive income through a corporation and c) restricting the conversion of corporate income into capital gains. Since the initial proposal was released, the government has made several amendments to its plan in response to widespread public comment and concern. The proposals contained in the 2018 budget have widely diverged from the original tax reform proposals.

This paper will conclude by discussing the reaction from medical doctors to the Consultation Paper and what the projected impact on the healthcare system would be. It will in turn compare the initial reaction to the Consultation Paper and the projected impact of the revised proposals. The ultimate objective of this paper is to assess the impact of CCPC tax reform on the medical profession and the services it provides.

1. WHAT IS A PRIVATE CORPORATION IN CANADA?

1.1 DEFINING A CCPC

For the purposes of tax legislation in Canada, s. 89(1) of the *Income Tax Act* (ITA) defines, broadly, a “private corporation” as:

a corporation that, at the particular time, is resident in Canada, is not a public corporation and is not controlled by one or more public corporations (other than prescribed venture capital corporations) or prescribed federal Crown corporations or by any combination thereof.²

The ITA also defines in s. 89(1) a Canadian corporation as a corporation that is resident in Canada at that time and was:

- a) incorporated in Canada, or
- (b) resident in Canada throughout the period that began on June 18, 1971 and that ends at that time, and for greater certainty, a corporation formed at any particular time by the amalgamation or merger of, or by a plan of arrangement or other corporate reorganization in respect of, two or more corporations is a Canadian corporation because of paragraph (a) only if
- (c) that reorganization took place under the laws of Canada or a province, and
- (d) each of those corporations was, immediately before the particular time, a Canadian corporation.

² R.S.C., 1985, c. 1 (5th Supp.).

The definition of a CCPC in s. 125(7) is a private corporation that is a Canadian corporation other than a corporation:

- (i) controlled, directly or indirectly in any manner whatever, by one or more non-resident persons, by one or more public corporations (other than a prescribed venture capital corporation), by one or more corporations described in paragraph (iii) below, or by any combination of them;
- (ii) that would, if each share of the capital stock of a corporation that is owned by a non-resident person or a public corporation (other than a prescribed venture capital corporation), or by a corporation described in paragraph (iii) below were owned by a particular person, be controlled by the particular person; or
- (iii) a class of the shares of the capital stock of which is listed on a prescribed stock exchange.

The ITA stipulates in s. 89(1) that a “public corporation” is generally one that has its shares listed on a designated Canadian stock exchange. Section 4800(1) of the *Income Tax Regulations*³ provides the prescribed circumstances for a corporation to be considered a public corporation under s. 89(1).

³ C.R.C., c.945.

The issue of what factors constitute “control” of a corporation has been the subject of much litigation. To provide some clarity to this term, s. 256(5.1) of the ITA provides a *de facto* control test that states that:

where the expression “controlled, directly or indirectly in any manner whatever,” is used, a corporation shall be considered to be so controlled by another corporation, person or group of persons (in this subsection referred to as the “controller”) at any time where, at that time, the controller has any direct or indirect influence that, if exercised, would result in control in fact of the corporation ...

It was only after 1988 that the definition of control for s. 125(7) was expanded to include *de facto* control.⁴ Although only *de facto* control is referenced in s. 256(5.1), the Department of Finance has taken the position that this definition also encompasses *de jure* control.⁵ *De jure* control has been held to mean “the right of control that rests in ownership as such a number of shares as carries with it the right to a majority of the votes in the election of the board of directors.”⁶

⁴ Canada, Department of Finance, *Explanatory Notes to Legislation Relating to Income Tax* (Ottawa: Department of Finance, June 1988) [Explanatory Notes].

⁵ Department of Finance, Interpretation Bulletin IT-64R4, “Canadian Controlled Private Corporation” (14 August 2001).

⁶ *Buckerfield's Limited et. al. v. MNR*, [1964] C.T.C. 504 at 5305.

1.2 SMALL BUSINESS DEDUCTION

The small business deduction is the colloquial term for the credit provided in s. 125 of the ITA. In very general terms, s.125 states that a CCPC may deduct from its tax an amount that is equal to the lesser of (1) 17% of its “active business” income⁷ carried on in Canada, and (2) its “business limit” of \$500,000 for the taxation year. It should be acknowledged that the term “small business deduction” is, in fact, a misnomer. To begin with, the “deduction” is actually a credit that is applied in a manner that effectively lowers a business’ tax burden.⁸ Further, this credit is available only to incorporated businesses operated as a CCPC. Therefore, the small business deduction is not available to all businesses, such as sole proprietorships, partnerships, corporations controlled by non-residents and corporations controlled by most public corporations. When a CCPC is associated with one or more CCPCs, then the group of CCPCs must share one small business deduction among the group.⁹

A CCPC will receive the small business deduction on its first \$500,000 of income even if its earnings exceed that threshold in a fiscal year. Under the federal taxation scheme, the small business deduction is reduced progressively on a straight-line basis until the CCPC’s

⁷ “Income from most businesses qualifies as active business income. However, active business income does not include investment income, income from a specified investment business, or income from a personal services business. Investment income, which is excluded from active business income, includes taxable capital gains less allowable capital losses, property income less property losses, and foreign business income” in “Active Business Income” *Tax Tips* (May 27, 2018) online: <<https://www.taxtips.ca/glossary/activebusinessincome.htm>>.

⁸ David G. Duff & Geoffrey Loomer, *Taxation of Business Organizations in Canada* (Toronto: LexisNexis, 2015) at 365 [Duff & Loomer].

⁹ Maureen Donnelly & Allister Young, “The Associated Corporation Rules: Getting Tax Reduction Under ‘Control’” (1998) 46:3 Can Tax J 589 at 620.

taxable capital increases from \$10 million to \$15 million.¹⁰ After reaching \$15 million in taxable capital, the small business tax rate does not apply at the federal level.¹¹ The majority of provinces have similar schemes for provincial taxation of small businesses.¹² The small business deduction, therefore, provides for significant tax savings both at the federal and provincial level.

A previous Canadian Minister of Finance, Joe Oliver, has characterized the small business deduction as important and fair on the policy ground that the deduction enables “small businesses to retain more earnings that can be used to reinvest and create jobs”.¹³ This preferential taxation for small businesses is justified for two major reasons:

- (i) The tax compliance and administrative costs are a heavier burden on smaller businesses compared to larger corporations. It is evident that tax compliance costs decrease relative to a firm’s overall size and capital¹⁴. Tax compliance costs for businesses of all sizes, however, are high in Canada, leading to the conclusion that simplifying the tax system would benefit the entire Canadian economy.¹⁵

¹⁰ Duanjie Chen & Jack M. Mintz, “Small Business Taxation: Revamping Incentives To Encourage Growth”(2011) 4:7 SPP Research Papers 6 [Chen & Mintz].

¹¹ *Ibid.*

¹² *Ibid.*

¹³ Hon. Joe Oliver, *Strong Leadership: A Balanced Budget, Low-Tax Plan for Jobs, Growth and Security*, 2015 Federal Budget (April 21, 2015) at 120.

¹⁴ François Vaillancourt, Édison Roy-César & Maria Silvia Barros, “Compliance and Administrative Costs of Taxation in Canada” (2013) The Fraser Institute at 89.

¹⁵ *Ibid.*

- (ii) Small businesses have less access to capital markets than their larger brethren and are usually confined to family, friends and banks as financing sources.¹⁶ In addition, financing costs to small business are typically significantly higher than larger business concerns.¹⁷ This disparity in the cost of funds between small and large businesses has also been used to justify providing the small business deduction to CCPCs.

In addition to the above major reasons, the small business deduction also helps integrate (discussed below) corporate and shareholder tax by reducing the rate on active business income through the gross-up and dividend credit system for taxable dividends, other than eligible dividends.¹⁸ This system aims to prevent double taxation (discussed below) at corporate and shareholder level.

Academics have levelled significant criticism, however, at the small business deduction for a variety of reasons. For instance, the limit of \$500,000 of active business income in a year or \$10 million in capital, whichever comes first, has been linked to creating a “taxation wall” as small firms may seek to avoid exceeding these parameters.¹⁹ It has been argued that the small business deduction actually impedes business growth as it provides an incentive either to remain small or to separate a growing corporation into two or more

¹⁶ Chen & Mintz *supra* note 10 at 19.

¹⁷ George A. Akerlof, “The Market for Lemons: Quality Uncertainty and the Market Mechanism” (1970) 48:3 *Quarterly Journal of Economics* at 492.

¹⁸ Duff & Loomer *supra* note 8 at 366.

¹⁹ Chen & Mintz *supra* note 10 at 5.

smaller, less efficient units.²⁰ This line of reasoning suggests that the small business deduction is too parsimonious; although, from the federal government's perspective, this deduction is the second most costly corporate tax expense, after the partial inclusion of capital gains²¹, resulting in an estimated \$3.17 billion of lost federal revenue annually.²² This amount will continue to climb as the rate is reduced and through the effects of inflation.²³

1.3 TAX INTEGRATION

The income tax system in Canada is designed, from a policy perspective, so that the combined corporate and personal tax paid by shareholders who earned income through a corporation, is equal to the income tax that would have been paid if the business income had been earned directly by the shareholders themselves.²⁴ Although not characterized as such in the ITA itself, this concept is commonly known as "tax integration". It should be noted, however, that the ITA's integration system does not currently achieve in all circumstances its full policy goal, as the current integration process results in shareholders paying more (in combined corporate taxes on a CCPC and personal income taxes on dividends if all net income is paid to the shareholders by way of dividend) than if the shareholders had earned directly the same income as the CCPC had earned.²⁵

²⁰ *Ibid.*

²¹ The current capital gains inclusion rate is 50%, meaning that an individual is only taxed on half of their realized capital gains.

²² Department of Finance, *2014 Tax Expenditures and Evaluations* (Ottawa: Department of Finance, 2015) at 23.

²³ *Ibid.*

²⁴ Paul Bleiwas & John Hudson, *Taxation of Private Corporations and Their Shareholders*, 4th ed (Toronto: Canadian Tax Foundation, 2010) at 2:4 [Bleiwas & Hudson].

²⁵ *Ibid.*

Canada integrates corporate and personal taxes by providing a dividend tax credit and excluding a portion of capital gains from taxation. This concept was first considered by the Carter Commission in its seminal analysis of, and recommendations for, the Canadian income tax system and subsequently implemented in the 1972 tax reforms.²⁶ When income is received by a CCPC and paid out as a dividend from post-tax earnings, the dividend is increased (“gross-up”) to reflect the corporate tax paid at the corporate level and a tax credit of that amount is deducted. The effect of these provisions is to recognize for the purposes of the recipient’s calculation of tax payable the income tax that the corporation has paid or is obliged to pay on its income.²⁷ Therefore, double taxation is avoided. When the corporate tax rate for small business changes, governments normally adjust dividend and capital gains tax rates to maintain small-business integration; thereby minimizing incentives to shift income between corporate and personal tax bases.²⁸

Before 2006, there was no mechanism to achieve integration of a corporation that was not eligible for the small business deduction that received actual business income.²⁹ To rectify this, the federal government introduced the eligible dividend regime so that larger CCPCs were no longer at a disadvantage.³⁰ Prior to 2006, taxes were higher for shareholders who earned a dividend through a corporation not subject to the small business deduction, as

²⁶ Canada, *Report of the Royal Commission on Taxation*, vol 4 (Ottawa: Queen’s Printer, 1966) [Report of the Royal Commission].

²⁷ Michael Wolfson et al, “Piercing the Veil - Private Corporations and the Income of the Affluent” (2016) 64:1 Can Tax J 1-30 at 4 [Wolfson et al].

²⁸ Jack Mintz & Michael Smart, “Income shifting, investment, and tax competition: theory and evidence from provincial taxation in Canada” (2004) 88:6 Journal of Public Economics 1149-1168 at 1158.

²⁹ *Ibid.*

³⁰ Department of Finance Canada: “Backgrounder: Enhanced Tax Credit for Dividends From Large Corporations” (Ottawa: 22 November, 2005) online: < https://www.fin.gc.ca/n05/data/05-082_1-eng.asp>.

opposed to earning it directly.³¹ This situation undermined the concept of tax integration. Enhanced gross-up and tax credits on eligible dividends, introduced in 2006, created integration for corporations which have active business income that exceeds the small business deduction.³²

³¹ Joanne E. Magee, *Insight into Canadian Income Tax 2007-2007* (Toronto: Carswell, 2006) at 499.

³² Bleiwas & Hudson *supra* note 24 at 2:10.

2. WHAT ARE THE TAXATION BENEFITS OF OWNING A PRIVATE CORPORATION?

This chapter discusses the primary benefits of CCPCs prior to the 2018 Federal Budget.

2.1 DEFERRAL OF PERSONAL TAXATION AND PASSIVE INVESTMENTS

Deferral of personal income tax is most commonly held to be the primary benefit of owning a private corporation.³³ If, in any year, owners of a private corporation leave all or a portion of the corporate earnings within a private corporation, then the owners can defer the payment of a substantial amount of income tax. Recall that the corporate tax rate paid by CCPCs is 15%, whereas income tax in the top marginal rate in Ontario is 53.53% in 2018.³⁴ Therefore, any net income in the corporation which is not distributed to the shareholders will be taxed at the corporate rate rather than the personal rate, leaving significantly more capital to invest. The end result is that a private corporation allows the business to amass a greater pool of investable capital from active business income compared with the amount of after-tax funds available where the same income is earned as personal income.³⁵ Consequently, this benefit results in conferring two advantages on the taxpayer; access to more initial capital as it has not been taxed at the personal rate and more time for the investment to accumulate more capital before personal taxation.

³³ Bleiwas & Hudson *supra* note 24 at 2:8.

³⁴ Wolfson et al *supra* note 27 at 4.

³⁵ Gabriel Baron, "Personal Tax Planning: Selected Considerations in the Use of Professional Corporations" (2013) 61:4 Can Tax J 1167-92 at 1170 [Baron]

The ability of those who use CCPCs to earn more through investments than those who earn income directly, contradicts the principle of tax integration.³⁶ There is no provision in the ITA that aligns the earnings available within a corporation with the after-tax capital that would be available to an individual. This difference is the main investment benefit conferred upon business owners.

The income saved by a person to invest passively can come from a variety of sources, such as regular business income, dividends, interest, capital gains and property income. For those whose savings exceed the limits of the tax-assisted and tax deferred savings vehicles (such as registered retirement savings plans, registered education savings plans and tax-free savings accounts) there is a benefit to hold any excess savings within a private corporation.³⁷ Since 2000, moreover, the gap between the corporate and personal tax rates at the combined federal and provincial level, have widened from an average of 26 to 37 percentage points across Canada. The federal income tax rates have risen over the past few years while the corporate rate has been lowered to encourage business growth and make Canada more internationally competitive.³⁸ Therefore, there is an ever-increasing incentive to hold income within a private corporation, passively investing and deferring tax.

³⁶ Tax Planning Using Private Corporations *supra* note 1 at 32.

³⁷ Department of Finance, “Backgrounder: Support for Small Business and Fairness for the Middle Class” (Ottawa: 16 October, 2017), online: <http://www.fin.gc.ca/n17/data/17-097_3-eng.asp>.

³⁸ Jinyan Li, Joanne Magee & Scott Wilkie, *Principles of Canadian Income Tax Law*, 9th Ed (Toronto: Thomson Reuters, 2017) at 420.

2.2 INCOME SPRINKLING

Income sprinkling (also known as “income shifting” or “income splitting”) is a second benefit commonly identified as an important benefit of owning a private corporation. Income sprinkling is the process whereby high-earning individuals shift income to lower-earning family members in order to reduce their personal tax burden.³⁹ Income shifting is achieved by family members (or a trust for their benefit) subscribing for shares in a private corporation and when dividends are paid, they are taxed at the respective family member’s personal tax rate.⁴⁰

The Department of Finance provided an example of income sprinkling:

Alicia and Brent are neighbours and business owners living in Nova Scotia. Alicia is a single mother with two children under the age of 18. Brent has a spouse and two children, ages 19 and 21; none of these family members has income.

Alicia’s household pays about \$21,000 more tax than Brent’s household under current rules. Both Alicia and Brent have incorporated businesses that earn \$180,000 before salary and taxes in 2017. Each receives \$100,000 in salary, and the remaining after-tax profits are paid out as dividends.

³⁹ Duff & Loomer *supra* note 8 at 761.

⁴⁰ Bleiwas & Hudson *supra* note 24 at 2:22.

The difference is that Alicia's corporation pays all of the dividends to her. Total taxes (corporate income taxes plus personal income taxes) add up to \$63,600 for Alicia's household.

Brent's spouse and adult children have no involvement in the business. They own shares in the corporation, for which they paid very little. Brent's corporation pays the remaining after-tax profits in equal amounts to these three family members as dividends. Total taxes paid by Brent's household equal \$42,600. Overall, Alicia's household pays \$21,000 more in taxes (roughly 50 per cent) than the amount paid by Brent's household.⁴¹

For many families, salaries are also paid to family members, to create a desirable salary-dividend combination.⁴² Salaries, however, may only be deductible in accordance with the ITA where services were provided and a similar remuneration would have been paid to an arm's length party. Additionally, the services must be *bona fide*, meaning related to the business of the corporation.⁴³

The courts have examined if salary payments received by family members conform to the ITA rules and are considered reasonable. In the case of *Maduke Foods Ltd. v. The Queen*,

⁴¹ Department of Finance of Canada, "Backgrounder: Income Sprinkling Using Private Corporations" (Ottawa: 16 October 2017), online: <http://www.fin.gc.ca/n17/data/17-097_1-eng.asp> [Backgrounder: Income Sprinkling].

⁴² *Ibid.*

⁴³ Canadian Revenue Agency, *Report of Proceedings of the Thirty-Third Tax Conference* (Toronto: Canadian Tax Foundation, 1982) at 757.

the taxpayer lost and income splitting was denied because the court determined that the salary amounts paid to the spouse and child of the shareholder far exceeded the value of the services performed.⁴⁴ The court reached a similar conclusion in *Raghavan v. The Queen*, where the spouse's salary and bonus was reduced to reflect the fair market value of the actual work performed.⁴⁵ There are, however, many instances where the courts will find that salaries and bonuses paid constituted reasonable remuneration.⁴⁶

2.2.1 "Kiddie Tax"

The benefits of income sprinkling are only effective, however, among adult members of a family owning a private corporation. The 1999 Federal Budget introduced s. 120.4 of the ITA, colloquially known as the "Kiddie Tax" rules. The ITA refers to s. 120.4 by the more dignified term of the tax on split income (TOSI). Section 120.4 applies the highest marginal tax rates to minors (under 18) who receive dividends or shareholder benefits from shares in a private corporation (as well as net business income from partnership or trust distributions) derived from a business carried on by a relative. The federal government implemented this measure to remove the incentive for high-income earners to split their income with their low-income minors.⁴⁷ A study conducted in 2014 determined that, since the "kiddie tax" legislation was enacted, an additional \$197 million of federal income tax

⁴⁴ 89 DTC 5458.

⁴⁵ 2007 DTC 5214.

⁴⁶ See *Roymac Mobile Homes Ltd. MNR* [1977] DTC 204 (TRB); *Fred & Ted's Construction Ltd v. MNR* 84 DTC 1530 (TCC); and *Ambulances BGR Inc. v. The Queen* [2005] DTC 472 (TCC).

⁴⁷ Maureen Donnelly, Joanne Magee, & Allister Young, "Income splitting and the new kiddie tax: major changes for minor children" (2000) 48:4 Can Tax J at 979.

revenue has been remitted each year, with a concomitant increase in provincial income tax revenues as well.⁴⁸

2.2.2 Estate Freeze

An estate freeze is a transaction in a private corporation, typically in which the person or persons (often parents) who created the value in the corporation receive shares equal to the then current value of the corporation (and hence are viewed as freezing the value of those existing shares to the current value of the corporation), while other family members or a trust subscribes at a nominal amount for shares that will receive the value of the growth or capital appreciation of the corporation.⁴⁹ The individual holding the freeze shares often exchange their existing common shares for a new class of voting, fixed value preferred shares. The individuals who hold the freeze shares would usually maintain voting control of the private corporation.⁵⁰ Thereafter, as dividends are paid on the growth shares, these dividends will be taxed in the hands of holders, often children, who typically pay income tax at much lower rates. In addition, the holders of the growth shares will benefit from any increase in the value of their shares and will be liable for any taxes payable in respect of that growth in value from the date of the estate freeze.⁵¹

⁴⁸ Andrew M. Bauer, Alan Macnaughton, & Anindya Sen, "Income Splitting and Anti-Avoidance Legislation: Evidence from the Canadian 'Kiddie Tax'" (2014) 22:6 International Tax and Public Finance at 912.

⁴⁹ Bleiwas & Hudson *supra* note 24 at 2:28.

⁵⁰ *Ibid.*

⁵¹ *Ibid.*

Estate freezes can be considered a subset of income sprinkling because the anticipated result of a typical estate freeze is the introduction of new shareholders into the business with the expectation that the new share structure will serve an income distribution purpose.⁵²

Estate freezes also serve an estate planning function. The use of a CCPC in an estate freeze can effect the transfer of capital from one generation to the next in a tax efficient manner. An estate freeze is the “transfer of appreciating assets to a subsequent generation”⁵³ where the older generation (for example, the parents) are effectively divested of future growth. This action minimizes the younger generations’ (for example, the children) capital gains tax (among other taxes) liabilities upon the death of the parents⁵⁴ (that would have to be paid by the estates of the parents). It is usually considered that individuals dispose of their assets at death for fair market value and an estate freeze typically reduces the value of the shares of a private corporation held by a parent at the date of death. Thus, if the value of the parents’ estates are reduced, then the tax paid by the parents’ estates is reduced and the value of the assets in the hands of the children is correspondingly raised.⁵⁵ From a policy perspective, estate freezes are justified on the grounds that they (1) enable the tax effective transfer of growth to the next generation, and (2) create an incentive for the children to

⁵² *Ibid.* at 3:42; Ron Choudhury, “2017 Canadian Budget Proposals - A Look Into The Future” (2017) 232 *Wolters Kluwer’s Global Tax Weekly*.

⁵³ David Louis & Samantha Prasad, *Implementing Estate Freezes*, 2nd ed (Toronto: CCH Canadian Limited, 2006) at 3.

⁵⁴ *Ibid.*

⁵⁵ *Ibid.*

invest in and grow the business.⁵⁶ Otherwise, operating businesses might have to be sold to pay the taxes owing on the death of the parents.⁵⁷

2.3 THE LIFETIME CAPITAL GAINS EXEMPTION

When a taxpayer realizes a capital gain upon the disposition of a share in a private corporation, the taxable portion of the gain that is to be included in income is usually one-half of the actual gain. That capital gain, however, may be wholly exempt from tax when the share is a “qualified small business corporation share”.⁵⁸ The lifetime capital gains exemption (LCGE) was created with the view of promoting investment and that “it is through capital investment that new ideas get implemented, new activities are generated and new jobs are created”.⁵⁹ The exemption intended to confer tax incentives on the operation of small businesses, in particular farming, and to ease the intergenerational transfer of these businesses.⁶⁰ Further, small business owners often do not have the same mechanisms to save and plan for retirement as other people, such as government or corporate pension plans or registered retirement savings plans.⁶¹ For example, many farmers do not have significant retirement savings, having invested their earnings in farmland and equipment, and they plan to sell the farm and use the proceeds to finance

⁵⁶ Robert C. Dunseith, “Estate Freezes: What, Why, When and How” (Paper delivered at the Legal Education Society of Alberta, 4 December 2012) at 2.

⁵⁷ *Ibid.*

⁵⁸ Section 110.6 ITA.

⁵⁹ Hon. Michael Wilson, “The Budget Speech” (delivered at the House of Commons 23 May 1985)

⁶⁰ Roy D. Hogg, “Targeting the Capital Gains Exception” (1995) 21: Supp The Canadian Experience of the Lifetime Capital Gains Exemption, Canadian Public Policy S193-S205 at S202.

⁶¹ Vijay M. Jog & Huntley Schaller, “Retirement Income and the Lifetime Capital Gains Exemption: The Case of Qualified Farm Property and Small Business Corporation Shares” (1995) 21: Supp The Canadian Experience of the Lifetime Capital Gains Exemption, Canadian Public Policy S136-S158 at S137 [Jog & Schaller].

their retirement. These farmers would have their retirement funds significantly reduced if their farm was subject to the capital gains tax on the entire value of the farm.

The LCGE began at \$500,000 but has since been indexed for inflation.⁶² As of 2018, the maximum LCGE is \$848,352. Only half of this amount is taxable due to capital gains being taxed at 50% of regular income, making the current capital gains deduction limit \$424,126.⁶³ The LCGE for farmers and fishers, however, is set at \$1 million and has remained at this level, unindexed, since 2015.⁶⁴

To qualify for the LCGE, a shareholder must show that, for the 24-month period immediately prior to the sale of the shares (holding period test), more than 50% of the fair market value of the private corporation's assets were used principally in an active business carried on primarily in Canada (asset test).⁶⁵ Further, the shareholder must prove that on the day of sale, all or substantially all of the fair market value of the private corporation's assets were used principally in an active business carried on primarily in Canada. The definition of what "substantially all" constitutes, however, is not surprisingly open to interpretation by the courts.⁶⁶

⁶² Duff & Loomer *supra* note 8 at 545.

⁶³ Canadian Revenue Agency, "Capital Gains Deduction: What is the deduction limit?" (Ottawa: 2017), <<https://www.canada.ca/en/revenue-agency/services/tax/individuals/topics/about-your-tax-return/tax-return/completing-a-tax-return/deductions-credits-expenses/line-254-capital-gains-deduction/what-deduction-limit.html>>.

⁶⁴ *Ibid.*

⁶⁵ Section 110.2 (1) ITA.

⁶⁶ For example see: *Wood v. M.N.R.* [1987] 1 C.T.C. 2391; *McDonald v. R.*, [1998] 4C.T.C. 2569; *Watts v. R.*, [2004] T.C.C. 535.

To satisfy both of the above asset tests, the “active business” applies to any business carried on by a private corporation that generates income from business activity as opposed to deriving “passive” income from property or passive investments.⁶⁷ Additionally, whether the assets are actually being used “principally” is determined on a case-by-case basis in the courts. The courts have held that if an asset was an integral aspect of business operations, the withdrawal of which would have a destabilizing effect, then it would be considered an asset used in an active business.⁶⁸

Access to the LCGE, additionally, can be multiplied by employing a family trust.⁶⁹ Usually, an estate freeze is conducted whereby the original shareholders exchange their common shares in a corporation for fixed value preferred shares, and the family trust subscribes for new equity growth shares.⁷⁰ Subsequently, the trustees can allocate any capital gains realized by the trust to beneficiaries who can claim the LCGE.⁷¹ The multiplication of access to the LCGE can result in significant tax savings for a family.

2.4 CONVERTING INCOME INTO CAPITAL GAINS

In a typical situation, a shareholder derives a return on shares held in a private corporation through periodic dividends paid on those shares.⁷² The corporation’s income that is used to pay dividends is already taxed within the corporation (dividends are paid out of after tax

⁶⁷ *Ollenberger v. Canada*, [2013] F.C.J. No. 286.

⁶⁸ See *Ensite Limited v. The Queen*, [1986] 2 S.C.R. 509; *Skidmore v. Canada*, [2000] F.C. No. 276; and *Reilly Estate v. Canada* [2007] T.C.J. No. 271.

⁶⁹ Bryan Hubbell, “Accessing the Lifetime Capital Gains Exemption” *Manning Elliot*, online:<<http://www.manningelliott.com/blog/accessing-lifetime-capital-gains-exemption>>.

⁷⁰ *Ibid.*

⁷¹ *Ibid.*

⁷² Duff & Loomer *supra* note 8 at 571.

monies) and the shareholder will pay tax on the dividends received.⁷³ The ITA intends for income earned through dividends to be taxed at the same overall rate as if the income had been earned by the individual through employment. The ITA accomplishes this outcome through the mechanism of integration, as discussed in Chapter 1.

In any situation, a shareholder has an incentive to try to re-characterize a dividend as capital gains because a capital gain is taxed at materially lower rates. The directors of a private corporation may exercise their discretion to distribute taxable dividends from the corporation's corporate surplus which is generally comprised of accumulated after-tax earnings and unrealized corporate value, minus its liabilities.⁷⁴ As an alternative, some private corporations have effectively converted what would otherwise be taxable dividends into capital gains through a process commonly referred to as "surplus stripping" or "dividend stripping". The mechanism of surplus stripping has been described as "situations where there is an actual distribution of accumulated corporate income and tax thereon is avoided by legal but artificial means."⁷⁵

The below situation is an example of surplus stripping:

Corporation A wholly owns Corporation B, which has one class of shares.

These shares have a fair market value of \$1 million and an adjusted cost base

of \$1 million. Corporation A contributes \$1 million of cash to Corporation B

⁷³ *Ibid.*

⁷⁴ Stephen R. Richardson & Kathryn E. Moore, "Canadian Experience with the Taxation of Capital Gains" (1995) 21:Suppl. Canadian Public Policy S77-S99 at S82.

⁷⁵ Report of the Royal Commission *supra* note 26 at 12.

in return for additional shares of the same class, with the result that Corporation A's shares of Corporation B have a fair market value of \$2 million and an adjusted cost base of \$2 million.

If Corporation B uses its \$1 million of cash to pay Corporation A a tax-deductible dividend of \$1 million, the fair market value of Corporation A's shares of Corporation B is reduced to \$1 million although their adjusted cost base remains at \$2 million. At this point, Corporation A has an unrealized capital loss of \$1 million on Corporation B's shares.

If Corporation A transfers an asset having a fair market value and unrealized capital gain of \$1 million to Corporation B on a tax-deferred basis, Corporation A could then sell its shares of Corporation B for \$2 million and take the position that there is no gain because the adjusted cost base of those shares is also \$2 million.⁷⁶

⁷⁶ Michael D. Templeton, "Budget 2015 – "Surplus Stripping" Anti-Avoidance Rule Amended" *McMillan Tax Bulletin* (April 2015), online: < <http://mcmillan.ca/Surplus-Stripping-Anti-Avoidance-Rule-Amended>>.

3. HOW DO MEDICAL DOCTORS INCORPORATE?

Medical doctors privately incorporate through professional corporations. Although the government reforms apply to all private corporations, the Department of Finance was particularly keen on curbing the benefits for professional corporations.⁷⁷ The number of incorporated professionals in Canada has tripled over the past fifteen years which has been of concern to the government.⁷⁸ This is because the main reasons for creating small business incentives, such as job creation and difficulty accessing capital markets, rarely apply to professional corporations.⁷⁹ Despite not fulfilling these reasons, professional corporations receive the most benefit from the small businesses incentives. In fact, traditional small businesses are 2.5 times less likely to receive a financial benefit from incorporation compared to their professional counterparts.⁸⁰ Therefore, this chapter will focus primarily on professional corporations. The primary difference between a professional corporation and other general CCPCS is that a professional corporation does not limit the liability of its members.⁸¹

⁷⁷ Tax Planning Using Private Corporations *supra* note 1 at 11.

⁷⁸ *Ibid.*

⁷⁹ Michael Wolfson & Scott Legree, “Policy Forum: Private Companies, Professionals, and Income Splitting—Recent Canadian Experience” (2015) 63:3 Can Tax J 717-737 at 721.

⁸⁰ David MacDonald, “Splitting the Difference: Who really benefits from small business income splitting” (2017) Canadian Centre for Policy Alternatives at 6 [MacDonald].

⁸¹ Bleiwas & Hudson *supra* note 24 at 2:27.

3.1 PROFESSIONAL CORPORATIONS

3.1.1 Eligibility To Create A Professional Corporation

The concept of a profession usually indicates a learned discipline that involves specialized knowledge and training with practical application and ethical standards.⁸² A professional corporation (a sub-set of private corporations) provides regulated professionals with the same advantages that other incorporated self-employed individuals are afforded. The professionals that most commonly incorporate are health practitioners, lawyers and accountants.⁸³

In *The Queen v. Campbell*, the court held that if provincial legislation allowed for professional incorporation, then the Canada Revenue Agency (CRA) must also recognize this form of carrying on a professional calling as well.⁸⁴ Although the CRA was initially wary of professional corporations, they have now embraced this structure as a legitimate form of tax planning. “[I]t appears that the Canada Revenue Agency . . . no longer views the use of a professional corporation as an unduly aggressive tax avoidance scheme.”⁸⁵

However, in Ontario, it was not until 2001 that the government allowed professional corporations.⁸⁶ Professionals incorporate under their respective provincial corporate statutes; most of the jurisdictions have similar rules surrounding professional

⁸² *Ibid.*

⁸³ *Ibid.*

⁸⁴ [1980] 80 DTC 6239.

⁸⁵ David G. Thompson, “Professional Corporations,” in *2005 British Columbia Tax Conference* (Toronto: Canadian Tax Foundation, 2005), 14:1-81, at 2.

⁸⁶ Ontario Ministry of Finance, “Information Bulletin: Professional Corporations” (Toronto: November 2001), online: < <https://www.fin.gov.on.ca/en/publications/2001/ibprof.html> >.

incorporation.⁸⁷ In Ontario, the *Business Corporations Act* (OBCA) is the governing statute for most private corporations.

Section 3.1 of the *OBCA* provides that:

Where the practice of a profession is governed by an Act, a professional corporation may practise the profession if,

- (a) that Act expressly permits the practice of the profession by a corporation and subject to the provisions of that Act; or
- (b) the profession is governed by an Act named in Schedule 1 of the *Regulated Health Professions Act, 1991*⁸⁸, one of the following Acts or a prescribed Act:

1. *Certified General Accountants Act, 2010*.
2. *Chartered Accountants Act, 2010*.
3. *Law Society Act, 1990*
4. *Social Work and Social Service Work Act, 1998*.
5. *Veterinarians Act, 2000, c. 42*.

⁸⁷ Vern Krishna, *Fundamentals of Income Tax Law, Volume 2: Corporate Tax* (Toronto: Carswell, 2015) at 328.

⁸⁸ Professions under this Act are: Audiology and Speech-Language Pathology, Chiropody and Podiatry, Chiropractic, Dental Hygiene, Dental Technology, Dentistry, Denturism, Dietetics, Homeopathy, Kinesiology, Massage Therapy, Medical Laboratory Technology, Medical Radiation Technology, Medicine, Midwifery, Naturopathy, Nursing, Occupational Therapy, Opticianry, Optometry, Pharmacy, Physiotherapy, Psychology, Psychotherapy, Respiratory Therapy, Traditional Chinese Medicine and Acupuncture.

3.1.2 Method Of Creating A Professional Corporation

Individual professionals usually create professional corporations from partnerships using one of the following operating structures:

- (i) The individual who is a member of a professional partnership transfers the individual's interest in the partnership to a newly incorporated professional corporation. The partnership then allocates income and expenses and makes distributions to that corporation; or
- (ii) The individual remains a partner of the professional partnership with respect to administrative services and functions. The newly incorporated professional corporation then renders professional services (performed by the professional corporation's shareholder who is the professional) to the partnership and bills the partnership for the professional corporation's services.⁸⁹

Each professional licensing body, such as The College of Physicians and Surgeons of Ontario, has its own individual requirements regarding professional registration. As with any corporation, a professional corporation must maintain proper books and records, including a minute book. The professional must also be an employee of the professional corporation and there is a requirement of proof, such as an employee contract.⁹⁰

Further, every professional corporation must maintain its own bank account and financial records. That corporation is the entity that should receive payment from the professional

⁸⁹ Baron *supra* note 35 at 1169.

⁹⁰ *Ibid* at 1185.

partnership for services rendered and then the professional may be paid a salary from the professional corporation in a separate transaction.⁹¹ Various provincial and federal tax accounts must be opened upon the creation of the professional corporation, including a goods and services tax or harmonized services tax registration and a registration regarding employees.⁹²

For income splitting purposes, it is common for other members of the professional's family to subscribe for shares in the professional corporation. The source of funds for the acquisition of such shares by family members should be independent from the professional corporation.⁹³ The shares should be valued at fair market value and be purchased with employment or investment income earned by each family member.⁹⁴ The independence of subscription sources of funds is vital if the shareholders of the professional corporation are to benefit from income splitting (discussed above).

All documentation and identification regarding the professional's business, including e-mail signatures, stationery and advertising material, should indicate that the professional's business is being carried out by a professional corporation. Indeed, many governing professional bodies mandate such disclosure.⁹⁵

⁹¹ *Ibid.*

⁹² *Ibid.*

⁹³ *Ibid.*

⁹⁴ *Ibid.*

⁹⁵ *Ibid.*

4. WHO CAN CAPITALIZE ON THE BENEFITS OF PRIVATE CORPORATIONS?

4.1 INCOME SPRINKLING

Although income sprinkling (generally described as the payment of dividends to family member shareholders of a CCPC with little or no active involvement in the CCPC's business) is available to all those who own a CCPC, the vast majority of owners never reap the benefits. A recent study conducted by the Canadian Centre for Policy Alternatives calculated that there are 904,000 small business economic families⁹⁶ in Canada, with only 23% benefiting from income sprinkling.⁹⁷ There are a multitude of reasons why only a select group of small businesses can capitalize on the use of income sprinkling. A business owner, for example, requires another eligible adult, earning materially less income, with whom to split the income generated within the CCPC. In most circumstances (96% of the time), Canadian couples reported both partners working and nearly one-third had fairly equal incomes.⁹⁸ Therefore, there would be no benefit to sprinkle income between two working partners with similar incomes or where the partner working outside of the business has a higher income.

Further, of the small businesses that engage in income sprinkling, 10% receive a tax benefit lower than \$1,000 in a year.⁹⁹ That sum is roughly equivalent to the cost of the

⁹⁶ An economic family includes all family members living in one household.

⁹⁷ MacDonald *supra* note 82 at 12 - It must be noted, however, that this statistic only refers to family members who reside outside of the family home.

⁹⁸ Statistics Canada, "Household income in Canada: Key results from the 2016 Census" (Ottawa: 13 September, 2017), online: <<https://www.statcan.gc.ca/daily-quotidien/170913/dq170913a-eng.htm>> [Statistics Canada].

⁹⁹ MacDonald *supra* note 80 at 12.

implementation and management of an income sprinkling structure.¹⁰⁰ Therefore, it can be concluded that 87% of economic families do not derive a net benefit from income splitting in any given year. Or conversely, only 13% of small business families receive an actual benefit from sprinkling income.¹⁰¹ Of that 13% it is reasonable to surmise that some CCPC's do not use income splitting primarily for tax motivations, but to compensate family members for working in, or other contributions to, the business.

It is evident that the advantages of income sprinkling are, not surprisingly, concentrated among those families with higher incomes. In fact, 64% of the total tax benefits of income splitting are shared among families in the top decile (that is, the top 10%) of family incomes in Canada (and 91% in the top two deciles).¹⁰² Indeed, families making more than \$216,000 annually (the top half of the top decile of families) receive nearly half of income splitting benefits.¹⁰³ By contrast, the middle class, a term which has multiple definitions, but is defined here to mean the middle 40% of families, determined by income, receive only 3% of the advantages of income sprinkling.¹⁰⁴

4.2 THE LIFETIME CAPITAL GAINS EXEMPTION

The intended recipients of the LCGE are primarily older business owners who are preparing for retirement. The LCGE was created with a view to benefit farm owners in

¹⁰⁰ *Ibid.*

¹⁰¹ *Ibid.*

¹⁰² *Ibid* at 16.

¹⁰³ *Ibid* at 15.

¹⁰⁴ Herbert J. Schuetze, "Income Splitting Among the Self-Employed" (2006) 39:4 Can Tax J. 1195-1220 at 1204

particular.¹⁰⁵ A 1995 study examined precisely which farm-owners received the benefits of the LCGE.¹⁰⁶ For the purposes of this study, “old” is defined to be those 62 and above, “middle-aged” is 47-61 and “young” is 46 and below.

Although the LCGE was intended to confer benefits on the old, just over 50% of the farming beneficiaries of the LCGE were actually old and this percentage decreased over time.¹⁰⁷ Just over a quarter of the claimants were middle-aged and about a fifth were young.¹⁰⁸ A great many Canadian farms are held in family owned corporations. Often if the next generation does not wish to continue farming, the farming generation which would typically hold all or the majority of the shares in the family farming corporation.¹⁰⁹ On retirement, the farming generation might lease out the farmland and eventually the corporation or the lands and equipment would be sold. Given this context, as one might expect, older farmers actually claim about two-thirds of the LCGE benefits, in terms of the actual monetary amount, while a quarter of the benefits went to middle-aged individuals and just one-tenth to the young.¹¹⁰

That 1995 study also analyzed the farming claimants based on income levels. They categorized high-income earners as those that earned at least \$53,215, middle-income earners as those who earned in between \$29,516 and \$53,214 and low-income earners

¹⁰⁵ Department of Finance, “Backgrounder: Support for Farming and Farm Families” (Ottawa: 19 October, 2017), online: < http://www.fin.gc.ca/n17/data/17-100_1-eng.asp>.

¹⁰⁶ Jog & Schaller *supra* note 61 at S145.

¹⁰⁷ *Ibid.*

¹⁰⁸ *Ibid.*

¹⁰⁹ Lee Littlejohns, “Maintaining a pure farm corporation” *Collins Barrow* (24 July 2013), online: < <https://www.collinsbarrow.com/en/cbn/publications/maintaining-a-pure-farm-corporation>>

¹¹⁰ Jog & Schaller *supra* note 61 at S145

earned below \$29,516.¹¹¹ Only 7% of farming LCGE claimants were considered high-income, 15% as middle-income and the remaining 78% as low-income.¹¹² While it appears that low-income farmers appear to be the chief beneficiaries of the LCGE, one might surmise that as farms continue to consolidate in Canada and the average Canadian farm size and income continues to increase, it would appear that the LCGE acts as an additional incentive for low-income farmers to sell out.

The farming LCGE constituted 64% of the total claims for the LCGE from the low-income group in Canada.¹¹³ Farming LCGE was 20% of the overall middle-income claims for the LCGE while it comprised of only 16% of the high-income claims for LCGE.¹¹⁴ Therefore, although older, retiring farmers are indeed benefiting from the LCGE, there are a large number of higher income individuals benefiting in other industries. Even overall, farms and fisheries are not the primary beneficiaries of the LCGE, although they have a larger deduction maximum. In 2017, farms and fisheries claiming LCGE cost the federal government \$695 million in revenue while LCGE claims by other small businesses (including professional corporations) amounted to \$840 million.¹¹⁵

4.3 PASSIVE INVESTMENTS AND TAXATION DEFERRAL

The federal government concluded that those who benefited from the tax deferral of passive income in CCPCs were typically wealthy. For instance, the government estimated that 80%

¹¹¹ *Ibid* at S148.

¹¹² *Ibid*.

¹¹³ *Ibid*.

¹¹⁴ *Ibid*.

¹¹⁵ John Lester, "Reviewing Federal Tax Expenditures" (2017) 17 Can Tax Foundation 1 at 17:16.

of the passive income earned in CCPCs came from CCPCs with an investment portfolio of at least \$2,000,000.¹¹⁶ The government determined that of the 1.8 million active CCPCs in Canada in 2015, only about 325,000 reported passive income.¹¹⁷ Of those, the government further estimated that 280,000 businesses may have benefitted from the deferral advantage of making passive investments in a CCPC.¹¹⁸ The government estimated that 88% of individuals who used CCPCs to make passive investments earned in excess of \$250,000 annually.¹¹⁹

Further, as the Department of Finance repeatedly noted, over 97% of CCPCs do not have taxable passive income that exceeds \$50,000.¹²⁰ It is estimated that approximately 47,000 CCPC's will be negatively affected by the reforms to passive investment.¹²¹ Therefore, the vast majority of business owners would not be affected immediately by the proposed changes to the ITA (discussed below), although it is not clear how many younger owners of CCPCs which do not currently benefit to a significant degree, expect to benefit in the future as they save for their own retirement.

4.4 CONVERTING INCOME INTO CAPITAL GAINS

According to the federal government, the tax planning benefits conferred by surplus stripping are intended to ease the intergenerational transfer of farms, fisheries and other

¹¹⁶ Department of Finance, *Progress for the Middle Class: Fall Economic Statement 2017* (Ottawa: Department of Finance Canada, 2017) at 51 [Fall Economic Statement].

¹¹⁷ *Ibid* at 50.

¹¹⁸ *Ibid*.

¹¹⁹ *Ibid*.

¹²⁰ *Ibid*.

¹²¹ Office of the Parliamentary Budget Officer, *Analysis of Changes to the Taxation of Corporate Passive Investment Income* (Ottawa: Parliamentary Budget Officer, 2017) at 1 [Parliamentary Budget Officer].

family owned businesses.¹²² The use of post-mortem pipelines and other tax planning vehicles (discussed below) certainly do aid in the transfer of business to a younger generation, however, the intended recipients of this benefit are certainly not the only ones.

In 2014 (the most recent year of published statistics), the CRA reported that there were 1,943,830 CCPCs in Canada, of these only 2.6% were farming and 0.2% were fishing corporations.¹²³ Further, the retained earnings of CCPCs totalled over \$1 trillion in 2014, yet only \$37.5 billion could be attributed to farming and merely \$1.4 billion to fishing.¹²⁴ Therefore, there is significant advantage being conferred on beneficiaries that are not the intended recipients.

Very few CCPCS, moreover, actually experience an intergenerational transfer. Due to the fragility of many family owned businesses, only 30% of them survive to the second generation and 15% to the third.¹²⁵ Therefore, although intergenerational transfers can be aided by converting income into capital gains, the majority of the beneficiaries are other non-intergenerational CCPCs.

¹²² Department of Finance Canada, “Targeted Tax Fairness Measures Will Protect Small Business Owners Including Farmers and Fishers” (Ottawa: 19 October, 2017), online: < <http://www.fin.gc.ca/n17/17-100-eng.asp> > [Targeted Tax Fairness Measures].

¹²³ Canada Revenue Agency, “Final Statistics 2016 edition (for the 2014 tax year)” (Ottawa: 2016), online: < <https://www.canada.ca/en/revenue-agency/programs/about-canada-revenue-agency-cra/income-statistics-gst-hst-statistics/final-statistics-2016-edition-2014-tax-year.html> >.

¹²⁴ *Ibid.*

¹²⁵ Susan Naylen Sorrell & Brian Kearn, “Succession Planning in a Family Business” (Paper 2015 delivered at the Prairie Provinces Tax Conference, Calgary, 1 June 2015) at 4.

5. WHY IS THE TAXATION OF MEDICAL DOCTORS UNIQUE?

Unlike other professionals (e.g. lawyers, accountants, dentists and pharmacists) who may also be affected by the Federal Government's proposed changes, medical doctors have far less control over their income. Almost all medical doctors must adhere to the applicable Provincial Government's (or Territory's) payment scale (e.g. Ontario Health Insurance Plan (OHIP) scale in Ontario). Unlike other professionals, therefore, who may increase their rates to accommodate potential losses, medical doctors are not at liberty to do so. Canadian medical doctors did not find a "loophole" to exploit in order to reduce their tax burden; rather it was actually recommended by various provincial governments and used as a negotiation tool. "If we were writing tax rules from a blank slate, Ottawa would clearly be right. There's no reason a doctor should be able to sprinkle income to family members when others can't. But doctors are right to feel that this was part of their deal."¹²⁶

In 2004, negotiations between the Ontario Liberal government and doctors were locked in a bitter stalemate. The government offered the ability to split income, in order to help come to a deal, which was the "turning point" according to the Ontario Medical Association (OMA).¹²⁷ The health minister, George Smitherman, acknowledged that income splitting was used to circumvent a restrictive budget and was "part and parcel of a package of benefits" with the "official stamp of approval on it."¹²⁸ Similar arrangements were made in other provinces. Dr. Manoj Vohra, president of Doctors Nova Scotia asserted that the "right

¹²⁶ Campbell Clark, "Ottawa should acknowledge doctors made a tax deal" *The Globe and Mail* (11 September 2017), online: < <https://www.theglobeandmail.com/opinion/ottawa-should-acknowledge-doctors-made-a-tax-deal/article36223760/>>.

¹²⁷ *Ibid.*

¹²⁸ *Ibid.*

to incorporate was given in lieu of the fact that we weren't going to increase the tariffs and the rates".¹²⁹ Further, Alberta Medical Association President Dr. Padraic Carr made a similar argument: "Professional corporations have been factored into our provincial negotiation and our relationships with government and physicians, some of it formally and some of it informally".¹³⁰ Medical doctors feel that the various Provincial Governments have reneged on good faith agreements, placing doctors in a unique tax situation, unlike many other business owners.

Further, unlike employees and many other professionals, including many nurses, medical doctors receive no pension and no benefits from their work (other than the ability to contribute to a registered retirement savings plan). Medical doctors are expected to be almost entirely self-reliant. If doctors operate their own clinics, they are run as businesses and must pay for all overheads such as staff, rent and equipment. The average Canadian medical doctor spends over 30% of their pre-tax income of overhead expenses.¹³¹ The tax benefits afforded by private corporations, therefore, are particularly important to medical doctors. To add to their financial burden, medical doctors carry disproportionately high student loans compared to other graduates. The average Canadian medical student graduates with over \$150,000 of debt, in contrast to the national average of around

¹²⁹ Brian Platt, "Doctors' fury over proposed federal tax changes could affect provincial health budgets", *National Post* (14 September 2017), online: < <http://nationalpost.com/news/politics/doctors-fury-over-proposed-federal-tax-changes-could-affect-provincial-health-budgets>>.

¹³⁰ *Ibid.*

¹³¹ Canadian Medical Association, *Small Business Perspectives of Physician Medical Practices in Canada* (Ottawa: Canadian Medical Association, 2016) [Canadian Medical Association].

\$28,000.¹³² Additionally, due to their lengthy education, medical doctors do not begin their careers until much later than most.

Overall, medical doctors' prior dealings with the government, remuneration and personal costs place them in a unique taxation circumstance.

¹³² Adam Kassam, "Overhaul residency program for doctors" *The Toronto Star* (20 February 2018), online: <<https://www.thestar.com/opinion/contributors/2018/02/20/overhaul-residency-program-for-doctors.html>>; Shirley Won, "Digging your way out of the cash crunch of university costs" *The Globe and Mail* (7 June 2017), online: <<https://www.theglobeandmail.com/report-on-business/careers/digging-your-way-out-of-the-cash-crunch-of-university-costs/article35229900/>>.

6. WHY DID THE GOVERNMENT PROPOSE REFORMS?

In 2015, the federal Liberal government was elected on a platform that included promises to Canadians to confront tax avoidance, in particular aggressive tax planning using private corporations.¹³³ The government believes that such tax planning is a significant issue and they are of the opinion that private corporations are being misused with the result that high-income earners are gaining tax advantages that are unavailable to many Canadians.¹³⁴

On July 18, 2017, the Department of Finance, headed by the Minister of Finance, Bill Morneau, published a Consultation Paper proposing tax reforms for private corporations. The objective of these changes was to “level the playing field” by removing the perceived imbalance of tax privileges that were conferred upon owners of private corporations.¹³⁵ After issuing this paper, the Ministry of Finance provided a consultation period and solicited comments through October 2, 2017. After the government indicated that they reviewed the thousands of responses, the government made some alternations to their proposed changes to the ITA. The government implemented their reforms in the 2018 Federal Budget, introduced in Parliament on February 27, 2018.

The government stated that it was not their intention to hamper small business but rather to correct a taxation system that “allows wealthy Canadians to incorporate to get a lower

¹³³ Liberal Party of Canada, “New Plan for a Strong Middle Class”, (Ottawa:2015) <<https://www.liberal.ca/files/2015/10/New-plan-for-a-strong-middle-class.pdf>> at 80.

¹³⁴ Tax Planning Using Private Corporations *supra* note 1 at 5.

¹³⁵ Bill Morneau, “Tax changes are about levelling the playing field” *The Globe and Mail* (5 September 2017), online: <<https://www.theglobeandmail.com/report-on-business/rob-commentary/tax-changes-are-about-levelling-the-playing-field/article36161429/>>.

tax rate than other Canadians.”¹³⁶ A large number of small business owners came forward, however, to voice their concerns about the proposed changes and the Canadian Federation of Independent Business called the measures the “most significant tax changes in decades” and launched a campaign to oppose it.¹³⁷ The federal government countered this assertion by claiming that the proposed measures were implemented so “that hard-working, middle-class small businesses, hard-working, middle-class farmers, do not get penalized by a measure that is aimed at wealthy Canadians”.¹³⁸

¹³⁶ Tonda MacCharles & Bruce Campion-Smith, “Finance minister tinkers with tax-reform proposals”, *The Toronto Star* (14 October 2017), <https://www.thestar.com/news/canada/2017/10/13/finance-minister-tinkers-with-tax-reform-proposals.html> [MacCharles & Smith].

¹³⁷ Guillaum Dubreuil, “Business groups unite, call on Ottawa to drop federal tax changes” *The Canadian Chamber of Commerce* (31 August 2017), <http://www.chamber.ca/media/news-releases/170831-business-groups-unite-call-on-ottawa-to-drop-federal-tax-changes/> [Dubreuil].

¹³⁸ MacCharles & Smith *supra* note 136.

7. WHAT ARE THE REFORMS?

7.1 INCOME SPRINKLING

The federal government asserted that through the use of private corporations, income sprinkling was providing unintended benefits to high-income individuals. They proposed to implement two general measures to help correct this perceived injustice:

- (i) Expand the TOSI rules; and
- (ii) Limit the number of claims to the LCGE.¹³⁹

7.1.1 Expand the TOSI Rules and Promote Tax Integrity

The TOSI rules apply to the split income of a specified individual. Under the current scheme, a specified individual is defined as a minor (under the age of 18) who is a Canadian resident and has a parent who is also a Canadian resident.¹⁴⁰ The types of income that are customarily subject to income sprinkling include dividends paid on unlisted shares of a corporation, income from a partnership or trust that is derived from a business, from professional services or from rental activity of a related person.¹⁴¹ It is important, however, to note that the TOSI rules do not apply to salary or wages (there is a limitation, though, on deductibility for minors).

¹³⁹ Tax Planning Using Private Corporations *supra* note 1 at 23.

¹⁴⁰ Section 102.4 ITA.

¹⁴¹ *Ibid.*

The TOSI rules take precedence over other anti-avoidance rules in relation to income sprinkling. The federal government is proposing to expand the application of the TOSI rules beyond the ambit of the “kiddie tax”. Specifically, the government proposed to:

- (i) expand the definition of a “specified individual”;
- (ii) apply a reasonableness test;
- (iii) introduce the concept of a “connected individual”; and
- (iv) increase tax integrity

7.1.1(a) Definition of “Specified Individual”

Under the current TOSI rules, a “specified individual” includes only a minor who receives split income.¹⁴² The federal government’s Consultation Paper proposes to extend the definition of a “specified individual” to encompass any Canadian resident who receives split income, regardless of age.¹⁴³

7.1.1(b) Reasonableness Test

The purpose of the reasonableness test is to ensure that a payment from a CCPC to an adult individual is equal to what that individual would have paid had that individual entered into a similar arrangement with an arm’s length corporation.

¹⁴² *Ibid.*

¹⁴³ Tax Planning Using Private Corporations *supra* note 1 at 24.

The reasonableness test would take into consideration the extent of labour contributions of a specified individual.¹⁴⁴ For specified individuals aged 18-24, the split income recipient would have to demonstrate that they actively engaged in the business to an extent that would justify the payments received.¹⁴⁵ For individuals 25 and over, they would have to demonstrate that their contribution to the business deserves to be remunerated by the wages paid.¹⁴⁶

The reasonableness test would also evaluate capital contributions by a specified individual. For individuals aged 18-24, the reasonableness test would examine the extent to which the amount received exceeds a legislatively prescribed maximum allowable return on the assets contributed by the individual in support of the business.¹⁴⁷ To assess individuals aged 25 or older, the reasonableness test examines their contributed assets or assumed risk to support the business.¹⁴⁸

The Consultation Paper, moreover, proposed that the TOSI rules should apply regardless of any reasonableness test in two circumstances. First, the TOSI rules would apply to all “compound income” of a specified individual under the age of 25.¹⁴⁹ In this case, “compound income” refers to the income derived from the investment of split income.¹⁵⁰ This exception aims to deter high-income individuals from using income sprinkling capital

¹⁴⁴ *Ibid* at 25.

¹⁴⁵ *Ibid.*

¹⁴⁶ *Ibid.*

¹⁴⁷ *Ibid.*

¹⁴⁸ *Ibid.*

¹⁴⁹ *Ibid* at 26.

¹⁵⁰ *Ibid.*

as seeding arrangements. Second, the TOSI rules would also apply under a newly proposed anti-avoidance rule. This new rule would affect property that was held or acquired to circumvent the TOSI rules.¹⁵¹ In both of these scenarios, the TOSI rules would apply without a reasonableness test.

7.1.1(c) Connected Individual

The government introduced the concept of a “connected individual”. This new definition defines a relationship, for the purposes of the TOSI rules, between the specified individual, the CCPC and an individual who is related to the specified individual.¹⁵² To be characterized as a connected individual, such related individual must be a Canadian resident and satisfy any of the following influence criteria:

- (i) **Strategic** - has *de facto* control over the corporation or is a member of a related group that has *de facto* control over the corporation;
- (ii) **Equity**- owns at least 10% of the equity of the corporation;
- (iii) **Earnings** - owns any level of shares of a services business if the services are primarily carried out by the individual or the income is primarily generated by the individual; and
- (iv) **Investment** - 10% or more of the value of the corporation’s property is derived from property acquired from the individual.¹⁵³

¹⁵¹ *Ibid.*

¹⁵² *Ibid.*

¹⁵³ *Ibid* at 27.

Depending on the business, there may be more than one connected individual and an individual may be both a connected individual and a specified individual in respect of the same corporation.¹⁵⁴

7.1.1(d) Supporting Measures to Improve Integrity

The government also proposed the following measures to the administration of the income tax rules relating to income sprinkling:

- (i) The introduction of tax reporting requirements regarding a trust's tax account number that would be similar to the requirements for corporations and partnerships regarding their own tax account numbers (commonly known as "business numbers"); and
- (ii) The introduction of measures so that the T5 tax reporting slip requirements regarding interest amounts apply to partnerships and trusts in the same circumstances in which they apply to corporations.¹⁵⁵

These new rules would improve the information reporting rules for trusts as trusts are also often used as an income sprinkling vehicle.¹⁵⁶

7.1.1(e) Additional Changes to the TOSI Rules

These additional rules were also proposed to correct the perceived imbalance in the income sprinkling system. The definition of split income would be expanded to include:

¹⁵⁴ *Ibid.*

¹⁵⁵ *Ibid* at 30.

¹⁵⁶ *Ibid.*

- (i) income from certain types of debt obligations;
- (ii) income derived from the profits from dispositions of certain property; and
- (iii) income on property derived from income previously subject to the TOSI rules, where the specified individual is under 25, including minors.¹⁵⁷

Further, the exclusion from a minor's split income with respect of certain inherited property was proposed to be expanded to adults aged 18-24 if they qualify as a "specified individual". Additionally, when testing for income-based benefits (e.g. personal tax credits), split income would be included as part of an individual's income.¹⁵⁸

The Consultation Paper also announced that certain income arising in the context of a tax-avoidance arrangement, or compound income (as described above in 7.1.1(b)), would be subject to the TOSI rules without regard to the reasonableness test.¹⁵⁹

The current joint and several tax liability rule with respect to the TOSI rules was proposed to be extended to apply in the case of adult specified individuals aged 18-24. A related individual who has sprinkled income with an adult specified individual aged 18-24 may be assessed joint liability with the adult specified individual for the adult specified individual's unpaid TOSI tax that arises in respect of that sprinkled (i.e., that part of the split) income.¹⁶⁰

¹⁵⁷ *Ibid* at 27.

¹⁵⁸ *Ibid*.

¹⁵⁹ *Ibid*.

¹⁶⁰ *Ibid* at 28.

7.1.1(f) Public Concerns

On September 25, 2017, the Canadian Tax Foundation hosted the “Policy Conference on Tax Planning Using Private Corporations” to focus on the proposed policies and potential effects of the changes.¹⁶¹ The most common concern raised by the attendees of the conference were the anticipated difficulties in applying the reasonableness test in practice. Brian Ernewein, Director General of Legislation for the Tax Policy Branch of the Department of Finance, responded to these concerns by stating, “I don’t think it’s beyond the wit of humankind to price capital or labour”.¹⁶² Canadians are still waiting for the detailed guidelines as to the application of the reasonableness test.

7.1.1(g) Department of Finance Update on Income Sprinkling

The Department of Finance announced on October 16, 2017 that it would be moving forward with its intention to curb income sprinkling via private corporations.¹⁶³ Public feedback on the federal government’s initial July 18, 2017 proposal, however, indicated that there was significant confusion surrounding how family businesses would be taxed.¹⁶⁴ To placate these concerns, the government committed to simplify the measures relating to family members who contribute to a family business. In particular, the government contemplated reducing the burden of having to establish contributions of spouses and family members including labour, capital, risk and past contributions.¹⁶⁵ Therefore, it is

¹⁶¹ Summary of the conference found in Cameron Mancell, “Tax Planning Using Private Corporations: Next Steps” *Wolters Kluwer’s Tax Topics* (12 October 2017)

¹⁶² *Ibid.*

¹⁶³ Backgrounder: Income Sprinkling *supra* note 41.

¹⁶⁴ *Ibid.*

¹⁶⁵ *Ibid.*

now reasonable to assume that the reasonableness test will be amended. The Department of Finance announced that they will release a more detailed draft proposal later in the year.

The government also announced in the same report that it would lower the federal business tax rate from 10.5% to 9% (a 10% rate effective January 1, 2018 and a 9% rate effective January 1, 2019).¹⁶⁶ The proposed reduction of the small business tax rate came at a time when the Liberal government was deflecting criticism over their proposed tax reforms that clearly incensed many small business owners. These owners alleged that the government's tax changes would hurt the same middle-class Canadians that the government asserts it wishes to help¹⁶⁷. The Department of Finance, under Bill Morneau, was evidently trying to reassure middle-class business owners that they were not the intended target of the government's proposed changes.

Due to the public concern, the Department of Finance released simplified and clarified amendments to the TOSI on December 13, 2017, effective in 2018 (for more details see Figure 1).¹⁶⁸ The TOSI does not apply on split income to the spouse of the business owner that is over the age of 65. This is equitable as it aligns with pension income and allows business owners to plan for retirement.¹⁶⁹ Further, the receipt of dividends and capital gains from business will be exempt from TOSI if the individual is an adult who has contributed

¹⁶⁶ *Ibid.*

¹⁶⁷ "Liberals pledge to cut small business tax rate to 9% amid backlash over proposed tax reforms", *CBC News* (October 16, 2017), online: <<http://www.cbc.ca/news/politics/small-business-tax-1.4356229>>.

¹⁶⁸ Department of Finance Canada: "Backgrounder on Simplified Measures to Address Income Sprinkling" (Ottawa: 13 December, 2017), online: <https://www.fin.gc.ca/n17/data/17-124_1-eng.asp>.

¹⁶⁹ *Ibid.*

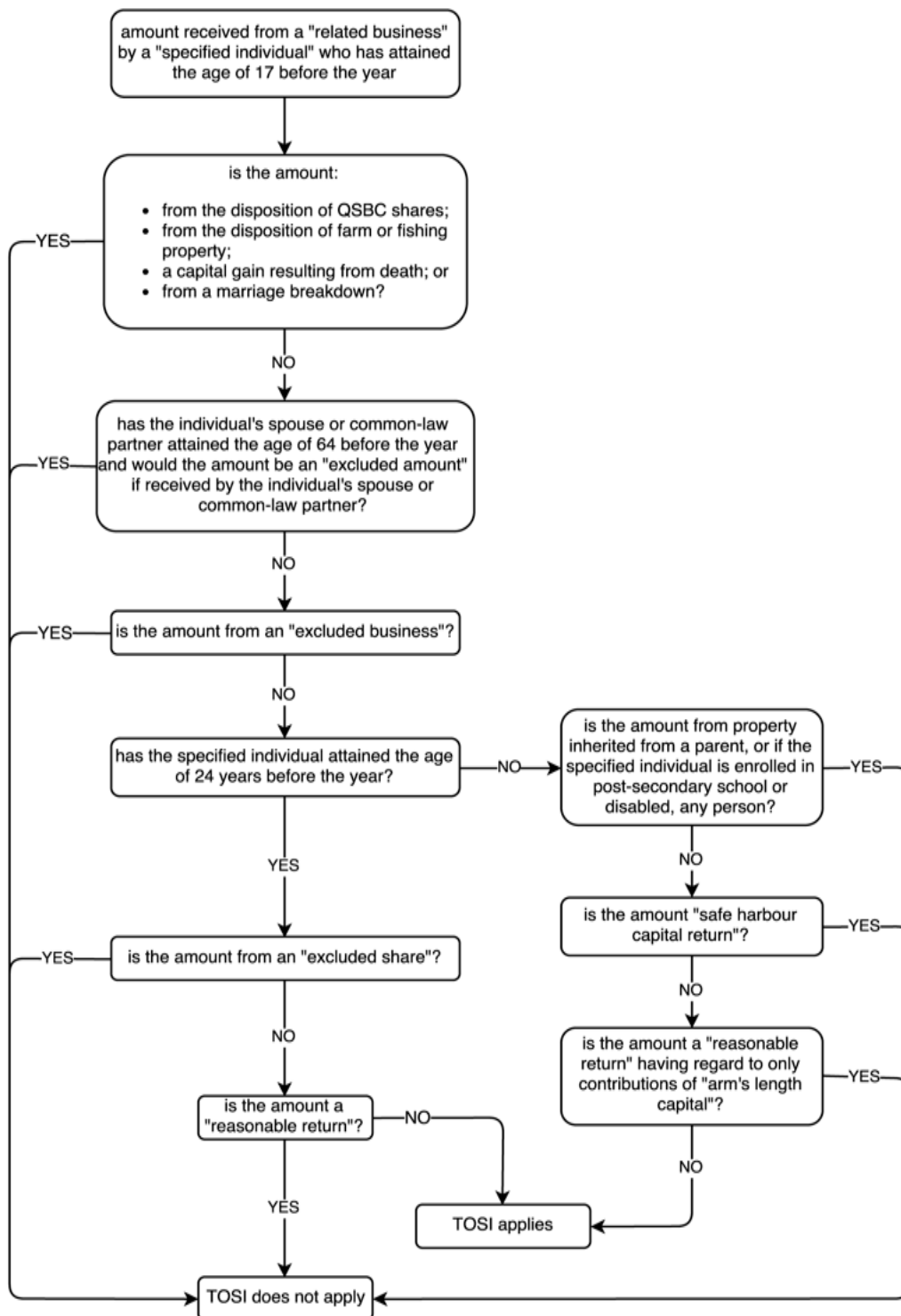
significant labour (20 hours a week) to the business over the year, or during any of the five previous years. Dividends and returns from shares will be excluded if the individual is at least age 25 and owns at least ten percent of the business that is earns less than 90% of its income from providing a service and the business is not a professional corporation.¹⁷⁰

A major revision to these provisions is that TOSI will not apply to compound income as tracking the original source of income would have proven very difficult. The new rules have widened the exclusion to the TOSI and therefore reduced the potential businesses affected by the reforms, from an estimated 50,000 to 45,000.¹⁷¹

¹⁷⁰ *Ibid.*

¹⁷¹ *Ibid.*

Figure 1: Flowchart of New TOSI Application¹⁷²



¹⁷² Image taken from Kevyn Nightingale, "Private Company Income Splitting Proposal Part 3: The Government Responds" *Wolters Kluwer's Tax Topics* (February 2018)

7.1.2 Multiplying Access to the Lifetime Capital Gains Exemption

In the July 18, 2017 Consultation Paper, the Department of Finance proposed three new restrictions on eligibility that would limit the ability of Canadian taxpayers to multiply access to the LCGE.

The first proposed restriction would have prohibited minors from accessing the LCGE.¹⁷³ Any individuals who realized a capital gain during a taxation year before reaching the age of 18 would have been unable to claim the LCGE.¹⁷⁴ Further, even if they realized capital gains after attaining the age of majority, any capital gains accrued before they reached 18 would not have qualified for the LCGE.¹⁷⁵

The second proposed restriction would have introduced a reasonableness test to determine if the LCGE would apply to a realization of capital gains.¹⁷⁶ This proposed restriction would have followed the same analytical approach as the reasonableness test for income sprinkling (set out above in 7.1.1(b)). The proposed LCGE reasonableness test would have seemingly applied, in particular, to shares of any corporation that would potentially be eligible for the LCGE.¹⁷⁷ As with the reasonableness test for income sprinkling, the LCGE reasonableness test would have only applied where the individual seeking access to the LCGE is related to a person who exercises considerable control over the business.¹⁷⁸

¹⁷³ Tax Planning Using Private Corporations *supra* note 1 at 29.

¹⁷⁴ *Ibid.*

¹⁷⁵ *Ibid.*

¹⁷⁶ *Ibid.*

¹⁷⁷ *Ibid.*

¹⁷⁸ *Ibid.*

Further, as with income sprinkling, the LCGE reasonableness test would also have assessed the labour and capital contributions made by the individual seeking to take advantage of the LCGE.¹⁷⁹ Under the LCGE reasonableness test, the shareholders must be compensated in a fashion comparable to what they would receive had they provided similar services or capital to an arm's length business.¹⁸⁰ As with income sprinkling, the standard applied to capital contributions made by 18-24 year olds is higher than older individuals.¹⁸¹

The third and final proposed restriction would have disallowed the application of the LCGE for capital gains that accrued when the subject property was held in trust.¹⁸² There would have been certain situations with trusts, however, that would have been exempt from this proposed restriction. The Department of Finance indicated that in some situations trusts might have been used where the purpose was not to exploit the multiplication of access to the LCGE.¹⁸³ Some of these proposed exempt trusts include: a) employee share ownership trusts where the employee is not related to the employer, b) spousal trusts, and c) alter ego trusts (settlor is a person 65 years or older, in which they are the sole beneficiary of the trust for their lifetime and allow them to transfer property on a tax deferred basis).¹⁸⁴

¹⁷⁹ *Ibid.*

¹⁸⁰ *Ibid.*

¹⁸¹ *Ibid.*

¹⁸² *Ibid.*

¹⁸³ *Ibid.*

¹⁸⁴ Section 70 ITA.

7.1.2(a) Government Revisions

On October 16, 2017, however, the Department of Finance announced that it would not be moving forward with the proposed changes to the rules governing the LCGE at that time.¹⁸⁵

The Department's communication stated:

A number of contributors to the consultation have identified potential unintended consequences associated with the proposed measures to address the multiplication of the lifetime capital gains exemption. For example, concerns were raised on the potential impact on intergenerational transfers of family businesses. Based on this feedback, the Government will not be moving forward with measures that limit access to the lifetime capital gains exemption.¹⁸⁶

7.2 PASSIVE INVESTMENTS INSIDE A PRIVATE CORPORATION

For many years, as a result of government tax policy, businesses have received a tax deferral on passive investment income because governments wish businesses to re-invest surplus revenues in their own growth. It is important to note, however, that once passive income is realized in a corporation it is taxed at the maximum marginal rate of the shareholder. In its Consultation Paper, the Department of Finance indicated that it believed it inappropriate to hold passive investments in a corporation.¹⁸⁷

¹⁸⁵ Backgrounder: Income Sprinkling *supra* note 41

¹⁸⁶ *Ibid.*

¹⁸⁷ Tax Planning Using Private Corporations *supra* note 1 at 32.

To combat this perceived unfairness the Department of Finance proposed two potential tax methods to alter the taxation of passive investing:

- (i) The Apportionment Method: this method entails tracking the source of income to be invested as well as any income that investment yields. The government acknowledges that this method would prove to be incredibly complicated and challenging.¹⁸⁸
- (ii) The Elective Method: this method would provide for default tax treatment of a CCPC's passive income. The passive income would be subject to non-refundable taxes and any dividends distributed from such income would be categorized as non-eligible dividends. Corporations would be able to elect out of this treatment if they are mostly taxed at the general rate. Therefore, non-refundable taxes would apply on passive income and treat dividends paid out from passive income as eligible dividends, which provide a higher dividend tax credit to the shareholder. If a corporation decides to elect out of default tax treatment, however, it would lose access to the small business deduction credit.¹⁸⁹

7.2.1 Government Revisions

On October 21, 2017, the government announced that after receiving public responses to the proposed changes, the government would be amending their proposed changes regarding holding passive investments within a private corporation. Specifically, the government stated that:

¹⁸⁸ *Ibid* at 47.

¹⁸⁹ *Ibid* at 49.

- (i) All past investments of CCPCs and income earned from those investments will be exempted from the proposed rules. Therefore, future gains on current investments will not be subject to the proposed changes, although there will be a practical issue of keeping pre-rule change and post-rule change passive investments segregated;
- (ii) The rules would introduce a passive income threshold of \$50,000 for future investments (equivalent to \$1 million in passive investments, based on a nominal 5% rate of return) to provide business owners with investment flexibility. Investments below this threshold will not incur the proposed tax increase; and
- (iii) Incentives for venture capitalists and angel investors would be maintained so that they can continue to invest in start-up Canadian business. The government will work alongside investors to establish how this objective will best be achieved.¹⁹⁰

The Minister of Finance, Bill Morneau, averred that these modifications to the original proposed changes would ensure that small businesses could continue to use passive investments, could save for the future and reinvest in their companies. Some in the media have suggested that imposing the \$50,000 threshold is a mechanism to prevent giving “wealthy people an unfair advantage over and above everyone else.”¹⁹¹ This conclusion is based on the statistic, stated above, that over 97% of CCPCs do not have taxable passive income that exceeds the \$50,000 limit.¹⁹²

¹⁹⁰ Department of Finance Canada: “Backgrounder: Passive Investment Income” (Ottawa: 21 October, 2017), online: < https://www.canada.ca/en/department-finance/news/2017/10/backgrounder_passiveinvestmentincome.html>.

¹⁹¹ “Bill Morneau unveils gentler tax proposals for private corporations”, *CBC News* (18 October 2017), online: < <http://www.cbc.ca/news/canada/new-brunswick/bill-morneau-tax-changes-1.4359860>>.

¹⁹² Fall Economic Statement *supra* note 116 at 51.

Although it has been asserted that the changes to passive investment would only impact a small portion of corporations, the amount increased tax revenue could be significant. The Parliamentary Budget Officer estimated that these proposed reforms could increase annual federal revenues by up to \$1 billion in the short term (one to two years after implementation), \$3 to \$4 billion over the medium term (five to ten years after implementation) and up to \$6 billion over the long term.¹⁹³

The federal government significantly amended the rules governing the taxation of passive investments in the 2018 budget and conceded that “its proposals could be very complex and add significant burdens on businesses.”¹⁹⁴ The budget does not directly affect taxes on passive income but rather the eligibility of a CCPC to qualify for the small business deduction. As the budget does not actually change the tax rate itself, there is no need to grandfather assets or keep separate accounts.

If investment in a CCPC does not accrue more than \$50,000 in passive income then budget proposes that the corporation would be entitled to a small business deduction up to \$500,000 (the small business limit). The budget further proposes that if a CCPC earns more than \$50,000 in passive income, the small business limit will be reduced by \$5 for each \$1 of passive income that exceeds that limit, calculated on a straight-line basis.¹⁹⁵ Therefore, once a CCPC earns \$150,000 (equivalent to \$3 million in passive investments, based on a

¹⁹³ Parliamentary Budget Officer *supra* note 121 at 1.

¹⁹⁴ Department of Finance Canada, *Budget 2018: Equality and Growth, A Strong Middle Class* (Ottawa: Department of Finance, 2018) at 73.

¹⁹⁵ *Ibid.*

nominal 5% rate of return) of passive income, the small business limit would be reduced to zero.

The 2018 budget further introduced the definition of “adjusted aggregate investment income”, which is income that is counted towards the passive investment limit. Adjusted aggregate investment income explicitly excludes capital gains that are realized from the sale of active business assets, as well as investment income that is incidental to the business.¹⁹⁶

7.3 CONVERTING INCOME INTO CAPITAL GAINS

Although there are specific rules in the ITA that prevent certain, specified surplus stripping transactions, the Supreme Court held in *Copthorne* that there is no general overriding provision in the ITA that prohibits surplus stripping.¹⁹⁷ Since 1988, however, the government has relied on the general anti-avoidance rule (GAAR) to increase surplus stripping liability.¹⁹⁸ The GAAR’s purpose is to “indicate the circumstances in which amounts received by a shareholder of a corporation from the corporation on a disposition of shares or other property are to be accounted for as a dividend.”¹⁹⁹

Section 84.1 is the rule in the ITA aimed at combatting the exchange of low paid-up capital or adjusted cost basis shares for corporate assets without paying a dividend and/or

¹⁹⁶ *Ibid* at 74.

¹⁹⁷ *Copthorne Holdings Ltd. v. Canada*, 2011 SCC 63, [2011] 3 S.C.R. 721.

¹⁹⁸ Duff & Loomer *supra* note 8 at 643.

¹⁹⁹ Canadian Revenue Agency, Information Circular, IC88-2S1, “General Anti-Avoidance Rule” (13 July 1990) at para 9.

combatting the exchange of high adjusted cost basis shares for corporate assets where the shares arose from a non-taxable transaction.²⁰⁰ Section 84.1 applies to a transaction where the following conditions are met:²⁰¹

- (i) A taxpayer disposes of shares;
- (i) The taxpayer is a resident of Canada that is not a corporation;
- (ii) The shares disposed of were capital property of the taxpayer;
- (iii) The shares are shares in the capital stock of a corporation resident in Canada (the “subject corporation”);
- (iv) The shares are disposed of to another corporation (the purchaser corporation”);
- (v) The taxpayer does not deal at arm's length with the purchaser corporation²⁰²; and
- (vi) Immediately after the disposition, the subject corporation is "connected" with the purchaser corporation (as defined in subsection 186(4)).

In order to uphold tax integration, if the above conditions are met, the paid-up capital of the shares taken for consideration could be reduced.²⁰³ Further, s. 84.1 may result in the taxpayer being deemed to receive a taxable dividend on any non-share considerations that is received.²⁰⁴

²⁰⁰ Bleiwas & Hudson *supra* note 24 at 4:21.

²⁰¹ List of conditions taken from *Côté-Létourneau c. R.*, 2007 D.T.C. 768 (T.C.C.) at para. 28.

²⁰² See: *Poulin v. The Queen*, 2016 TCC 154.

²⁰³ Bleiwas & Hudson *supra* note 24 at 4:24.

²⁰⁴ *Ibid.*

The existing rules under s. 84.1 modify adjusted cost basis to subtract the soft cost base, which is the 1972 valuation day value or any basis deriving from the claiming of the LCGE.²⁰⁵ Under its current form, s. 84.1 only applies when the proceeds from a transaction exceed the “hard” adjusted cost basis, where capital gains tax is paid by non-arm’s length parties.

It was estimated that during the 2017 fiscal year, the federal government had forgone \$273,000,000 in revenue due to the use of surplus stripping.²⁰⁶ In its July 18, 2017 Consultation Paper, the Department of Finance proposed two measures to address this matter:

- (i) Expanding the application of s. 84.1 to include the reduction of the “hard” adjusted cost base of private corporations’ shares, that would otherwise have been increased as a result of a related party transaction; and
- (ii) Amending the ITA to add an anti-avoidance rule (proposed s. 246.1) that would classify non-share consideration as a taxable dividend where a non-arm’s length transaction was conducted with the purpose of paying an individual shareholder a non-share consideration that is otherwise treated as a capital gain out of a private corporation’s surplus to significantly reduce the corporation’s assets.²⁰⁷

²⁰⁵ Section 84.1(2)(a.1) ITA

²⁰⁶ Office of the Parliamentary Budget Officer, *Cost Estimate for Bill C-274 An Act to amend the Income Tax Act (transfer of small business or family farm or fishing corporation)* (Ottawa: Parliamentary Budget Officer, 2017).

²⁰⁷ Tax Planning Using Private Corporations *supra* note 1 at 60.

7.3.1 Section 84.1:

The proposed amendments to s. 84.1 would effectively disallow the use of a non-arm's length transaction to "step up" the hard adjusted cost basis of shares of a corporation.²⁰⁸ It is only the "hard" cost base of the shares that may be recovered from a corporation without incurring additional personal tax. Where an individual transfers such shares of a particular corporation to another non-arm's length corporation, the cost base of such shares would now be reduced by any capital gains realized by the taxpayer or any individual who the taxpayer did not deal with at arm's length.²⁰⁹ Thus, the individual would receive a lower amount of non-share consideration.

Additionally, the proposed amendment could have an adverse impact on common estate planning techniques used to avoid double taxation.²¹⁰ Previously, the CRA had asserted that pipeline transactions are not subject to the s. 84.1 or the GAAR, however, the government altered that opinion in its Consultation Paper.²¹¹ Post-mortem pipeline transactions are used for many intergenerational transfers of businesses and may well have been harmed by the proposed amendments. After death, capital gains are realized and the adjusted cost basis of the estate's shares is increased to reflect the fair market value at the time of death.²¹² A post-mortem pipeline allows for a tax-free removal of assets from the

²⁰⁸ *Ibid.*

²⁰⁹ Explanatory Notes *supra* note 4 at 42.

²¹⁰ "Finance proposals on 'Tax Planning Using Private Corporations': Capital gains implications" *Deloitte Canadian Tax Alert* (7 September 2017), online: <
<https://www2.deloitte.com/content/dam/Deloitte/ca/Documents/tax/ca-en-DP-capigal-gains-491401-AODA.pdf>> [Deloitte].

²¹¹ Norman C. Tobias, *Taxation of Corporations, Partnerships and Trusts*, 5th Ed (Toronto: Thomson Reuters, 2017).

²¹² *Ibid.*

estate equal to the gain realized upon death.²¹³ This is achieved by the estate selling the inherited shares to a newly created arms-length company for a promissory note equal to the adjusted cost basis of the shares.²¹⁴ The estate will subsequently repurchase the shares held by the arms-length company and the arms-length company will receive a tax-free deemed dividend. The deemed dividend will be used to repay the note. As a result, if s. 84.1 was amended, business owners would have needed to resort to other means of estate planning or else face double taxation upon death.

7.3.2 Section 246.1:

Section 246.1 would have been a new anti-avoidance provision that intended to prevent corporate surplus from being distributed to a shareholder on a tax-reduced basis in a non-arm's length context; rather than receiving a taxable dividend (known as surplus stripping). This provision would have applied where:

- (i) The individual is a Canadian resident in that year;
- (ii) The parties are not arm's length;
- (iii) There is a disposition of property or an increase or decrease to paid-up capital of the corporation through a transaction; and
- (iv) It would be reasonable to consider that the purpose of the transaction was to significantly reduce the assets of a private corporation to avoid personal taxes.²¹⁵

²¹³ *Ibid.*

²¹⁴ *Ibid.*

²¹⁵ Department of Finance, *Tax Planning Using Private Corporations: Explanatory Notes* (Ottawa: Department of Finance Canada, 2017) at 45.

In this case, s. 246.1 would have deemed the individual to have received a taxable dividend and the individual would be taxed accordingly. Since the original proposed change, the Department of Finance further described their thinking about the fourth prong of the above test. The Department stated that:

An individual is to be considered to be avoiding any part of tax otherwise payable with respect to the amount received or receivable if the amount of tax payable by the individual is less than the amount of tax that the individual would have had to pay in respect of the receipt or receivable had the corporation instead paid a taxable dividend immediately before the transaction.²¹⁶

This particular stipulation caused concern because it could be reasonably argued that any capital dividend could be seen as tax avoidance, by virtue of such dividend being tax-free.²¹⁷

7.3.3 Government Revisions

On October 19, 2017, the Department of Finance released a statement that the federal government would not be moving forward on their proposed measures regarding converting income into capital gains. During the public consultation period, the Government heard many concerns that these proposed changes would be harmful to businesses; particularly in respect of taxation upon death and intergenerational business

²¹⁶ *Ibid.*

²¹⁷ Deloitte *supra* note 210.

transfers.²¹⁸ It was estimated that the purchase price of a family business from one generation to the next would have risen from about 26.5% of capital gains rate to a dividend rate of 45%.²¹⁹ Finance Minister, Bill Morneau stated that:

As we move forward with creating a fairer tax system for the middle class, we will work to protect family farms and fisheries, and the ability of all family-run business owners to pass down the results of their hard work to the next generation²²⁰.

²¹⁸ Targeted Tax Fairness Measures *supra* note 122.

²¹⁹ “2017 Special Update on Taxation” *Thortinsons* (10 October 2017), online: <<https://www.thor.ca/wp-content/uploads/2017/10/Toronto-Tax-Update-October-10-2017.pdf>>.

²²⁰ Targeted Tax Fairness Measures *supra* note 122.

8. THE EFFECTS OF THE REFORMS ON THE MEDICAL PROFESSION

8.1 RESPONSE OF MEDICAL DOCTORS TO THE CONSULTATION PAPER

As discussed above, many medical doctors feel that incorporation is a necessary instrument given their unique financial situation, as well as part of a negotiated remuneration package. Opponents of reform often emphasize the fact that “[a] medical business is unique...because we are a public service.”²²¹ Medical doctors do not set their own fees and “have no way to adjust our income other than working more hours”.²²² Many believe that the benefits conferred by incorporation actually create equity.

There is also a feeling within the medical community, following the reform proposals, that doctors are being targeted by the government and that their work is undervalued. Some medical doctors regard the reform as being “an attack on physicians by our prime minister.”²²³ They note that general public perception is that all doctors are wealthy and they should “put a little water in their fine wine”.²²⁴ This sentiment has left many medical doctors feeling “villainized and underappreciated”.²²⁵ In fact, a survey on Ontario medical doctors, trainees and students found that over 70% of respondents felt “attacked and

²²¹ Canadian Medical Association *supra* note 131 at 5.

²²² *Ibid.*

²²³ Jeff Lagerquist, “Doctors divided on best medicine for Canada's tax system” *CTV News* (28 September 2017), online: <<https://www.ctvnews.ca/business/doctors-divided-on-best-medicine-for-canada-s-tax-system-1.3610231>> [Lagerquist].

²²⁴ André Picard, “Ontario doctors’ group lashes out against province’s tentative deal” *The Globe and Mail* (24 March 2017), online: <<https://www.theglobeandmail.com/news/national/concerned-ontario-doctors-lash-out-against-provinces-tentative-deal/article31124456/>>.

²²⁵ Adam Stewart, “Canadian Doctors Like Me Are Starting To Look For The Exit” *Huffington Post* (16 August 2017), online: <https://www.huffingtonpost.ca/adam-stewart/canadian-doctors-like-me-are-starting-to-look-for-the-exit_a_23077616/>.

vilified” by the Canadian government.²²⁶ Particularly the language employed by the government such as “closing loopholes” and purporting that medical doctors do not “pay their fair share” has angered many doctors.²²⁷

It is important to note, however, that resistance to reform is not unanimously held among the medical profession. A portion of doctors felt “really fed up with the narrative that our colleagues were putting forth and that our medical associations were putting forth as the only opinion out there”.²²⁸ Proponents of tax reform believe that it “seems unfair that these benefits are not available to Canadians with similar incomes who cannot incorporate.”²²⁹ They also point to income disparity, as the average Canadian medical doctor earns \$339,000 annually, whereas the average employed Canadian earns \$51,000 annually.²³⁰

Medical doctors in favour of tax reform assert that only the reform of the taxation of professional corporations would result in a fair and equitable tax system. Medical doctors in favour of reform further assert that additional tax revenue is greatly needed “to fund social programs such as affordable housing, pharmacare, social assistance, legal aid, and the healthcare system itself.”²³¹ In fact, an open letter to Morneau applauding CCPC reform

²²⁶ Concerned Ontario Doctors, *Survey of Ontario Doctors & Trainees: Burnout, Ongoing Healthcare Cuts & Proposed Federal Taxation Changes* (Ottawa: Concerned Ontario Doctors, 2017) [Concerned Ontario Doctors].

²²⁷ Doctors of BC, *Submission to the Federal Government on Proposed Tax Changes* (Vancouver: British Columbia Medical Association, 2017) at 3 [Doctors of BC].

²²⁸ Dr. Sarah Giles in “Some doctors urging Bill Morneau to go ahead with tax changes” *CBC* (18 September 2017), online: < <http://www.cbc.ca/news/business/some-doctors-urging-bill-morneau-to-go-ahead-with-tax-changes-1.4294521>>.

²²⁹ *Ibid.*

²³⁰ Canadian Institute for Health Information, “Infographic: A profile of physicians in Canada in 2016” (Ottawa: 2017), online: < <https://www.cihi.ca/en/infographic-a-profile-of-physicians-in-canada-in-2016>>; Statistics Canada *supra* note 98.

²³¹ Lagerquist *supra* note 233.

was published following the July 2017 proposals, and was signed by over 490 medical doctors and students.²³²

8.2 IMPACT OF THE CONSULTATION PAPER ON THE HEALTHCARE SYSTEM

Despite some positive responses, there was an outpouring of indignation and frustration from the medical community following the proposed reforms. Knowing that CCPC tax changes were likely imminent, the Canadian Medical Association (“CMA”) conducted a survey of its members in 2016 to assess the impact of potential reform. This study found that over half (54%) of CMA’s members would likely reduce their working hours if the reforms were implemented, while 42% would likely reduce their office staff.²³³ The CMA also found that around a quarter of their members would retire earlier (24%), relocate to another province or territory (26%) or move to a foreign jurisdiction (22%).²³⁴

Concerned Ontario Doctors (“COD”) and the New Brunswick Medical Society (“NBMS”) conducted similar surveys in following the government’s proposals, which found that 75% and 65% of respective respondents would reduce working hours.²³⁵ Further, while only 11.23% of COD respondents claimed they would leave Ontario, 46% of NBMS respondents replied that they would likely leave New Brunswick (second highest provincial income tax rate).²³⁶ 21% of COD respondents asserted they would leave Canada if the reforms were implemented. A quarter of the respondents of both surveys replied that they

²³² See: <<https://docsandtaxes.wordpress.com/>>.

²³³ Canadian Medical Association *supra* note 131 at 2.

²³⁴ *Ibid.*

²³⁵ Concerned Ontario Doctors *supra* note 226; The New Brunswick Medical Society, *Proposed federal tax measures could seriously impact healthcare delivery in NB* (Fredericton, The New Brunswick Medical Society, 2017).

²³⁶ *Ibid.*

would retire earlier upon the reform of CCPC taxation. The NBMS issued a statement that “[t]he proposed changes to tax rules governing private corporations could seriously impact the province’s ability to recruit and retain the doctors that are desperately needed throughout the health care system.”²³⁷

There appears to be a belief throughout the medical community that changes to CCPC taxation will have an adverse effect on healthcare. When a Doctors of BC Survey asked medical doctors whether they agreed with the statement “the proposed tax changes will have a negative impact on patient care,” 77% of total respondents agreed, 9% disagreed, and 14% were unsure. Even among medical doctors who were not incorporated, 64% agreed, 21% disagreed, and 15% were unsure about the statement.²³⁸

An adverse impact that became a concern after the federal proposal, was the recruitment and retention of medical doctors. The jurisdictions that are likely to be the most impacted are “rural, generalist-based system[s]” as they are often viewed as the least desirable by medical professionals and graduates.²³⁹ The Newfoundland and Labrador Medical Association is particularly worried that the province will not be able to attract medical doctors. Family physicians in Newfoundland and Labrador are the lowest paid compared to every other province but pay some of the highest taxes in the country.²⁴⁰ In light of the

²³⁷ *Ibid.*

²³⁸ Doctors of BC *supra* note 227 at 3.

²³⁹ Newfoundland and Labrador Medical Association, “Proposed federal tax changes will impact recruitment and retention of doctors” (St. John’s: 28 September 2018), online: <http://nlma.nl.ca/FileManager/News-Releases/docs/2017/2017.09.28_NLMA_News_Release_Proposed_federal_tax_changes_will_impact_recruitment_and_retention_of_doctors.pdf>.

²⁴⁰ *Ibid.*

tax proposals, 62% of Newfoundland and Labrador medical doctors would be willing to leave the province, which would be detrimental to their healthcare system.²⁴¹ More rural jurisdictions, in particular, were concerned about their ability to recruit international medical doctors if the proposed changes were to be implemented. 36% of Newfoundland and Labrador's doctors are recruited internationally and the province's ability to attract international professionals may be hampered by tax reforms.²⁴²

The healthcare system in Nova Scotia is also particularly vulnerable to reform. There are approximately 90,000 Nova Scotians without a family doctor.²⁴³ The provincial government estimated that it would need to recruit 512 full-time family physicians over the next ten years in order to replace leaving/retiring doctors, as well as address the increase in patient need.²⁴⁴ The province further approximates that it will need to recruit 558 new specialists over the next ten years.²⁴⁵ This problem is further compounded by the fact that Nova Scotian medical doctors are paid, on average, less than the national average yet pay higher taxes. With the threat of CCPC tax reform, 52% of Nova Scotian medical doctors responded that they would consider leaving the province.²⁴⁶

The inability to recruit and retain medical doctors will put a significant strain on the healthcare system, which may lead to more burnout. Burnout is medically characterized as

²⁴¹ *Ibid.*

²⁴² *Ibid.*

²⁴³ Nancy MacCready-Williams, *Doctors Nova Scotia's submission to the Senate Committee's Study on the Minister of Finance's proposed changes to the Income Tax Act respecting the taxation of private corporations and the tax planning strategies involved* (Halifax: Doctors Nova Scotia, 2017) at 2.

²⁴⁴ *Ibid.*

²⁴⁵ *Ibid.*

²⁴⁶ *Ibid.*

“the chronic state of being out of sync with one or more aspects of your life, and the result is a loss of energy, enthusiasm, and confidence.”²⁴⁷ A person experiencing symptoms of burnout will usually see a deterioration in their physical and mental well-being.²⁴⁸ Last year, the CMA conducted a survey that found 54% of Canadian medical doctors are showing symptoms of burnout and that their suicide rate is three times the national average.²⁴⁹ These statistics are so concerning that the CMA President declared, “[i]f a private business had those statistics, we would fire the management.”²⁵⁰

One of the main causes of burnout is work overload, which will only increase if provinces are unable to retain their medical doctors. The average Canadian medical doctor works 50 hours a week, in addition to spending 20-30 hours on call.²⁵¹ In comparison, the average employed Canadian works 36.6 hours a week.²⁵² An inadequate number of health professionals will require medical doctors to work increasingly longer hours, which will result in more burnout.

The proposed taxation reforms to CCPCs may cause medical doctors to feel like their job has an insufficient reward, which is another major reason for burnout. It is not just a decrease in remuneration due to potential changes to CCPC taxation that has upset medical

²⁴⁷ Paula Davis-Laack, “Six Sources of Burnout at Work” *Psychology Today* (29 August 2013), online: <<https://www.psychologytoday.com/ca/blog/pressure-proof/201308/six-sources-burnout-work>>.

²⁴⁸ *Ibid.*

²⁴⁹ André Picard, “CMA head criticizes federal corporate tax plan, says it will harm patient care” *The Globe and Mail* (21 August 2017), online: <https://www.theglobeandmail.com/news/national/cma-head-criticizes-federal-corporate-tax-plan-says-it-will-harm-patient-care/article36039222/?cmpid=rss1&click=sf_globe>.

²⁵⁰ *Ibid.*

²⁵¹ National Physician Survey, *National Results by FP/GP or Other Specialist, Sex, Age and All Physicians* (Ottawa: Canadian Medical Association, 2014).

²⁵² “Canada’s Longest Workweek: Alberta’s Average Workweek Is The Longest In The Country” *The Huffington Post* (14 September 2013), online: <https://www.huffingtonpost.ca/2013/09/14/canadas-longest-workweek-alberta_n_3922973.html>.

doctors. As discussed above, many medical doctors feel that they are undervalued and taken for granted, leading to their work feeling less rewarding than it once did.²⁵³ Burnout symptoms often occur when medical doctors “don’t feel as respected... don’t feel as valued and that becomes morally challenging.”²⁵⁴

“Healthier doctors lead to healthier patients and healthier symptoms”, therefore when medical doctors experience the effects of burnout, it harms patients.²⁵⁵ Burnout significantly attributes to mistakes by medical doctors.²⁵⁶ In a profession where errors can be fatal, it is so important that medical doctors are as astute and accurate as possible. An American study found that surgeons suffering from symptoms of burnout are 5-11% more likely to make a mistake than those who are not.²⁵⁷ Burnt-out medical doctors are also less likely to engage in health policy and planning, as well as less likely to advocate for patient needs.²⁵⁸ Burnout is also a driving cause of early retirement among medical doctors. It was estimated in 2010 that the cost of early retirement of medical doctors in Canada was \$213.1 million.²⁵⁹

²⁵³ Sohail Gandhi, “Burnt-Out Doctors Are Facing A Health-Care Crisis Of Their Own” *The Huffington Post* (23 August 17), online: < https://www.huffingtonpost.ca/sohail-gandhi/burn-out-doctors-are-facing-a-health-care-crisis-of-their-own_a_23158087/> [Gandhi].

²⁵⁴ Dr. Dan Horvat in Lauren Vogel, “CMA must address physician burnout, pharmacare, say doctors” (2017) 187:36 CMAJ 1171 at 1171.

²⁵⁵ Dr. Gigi Osler in *Ibid.*

²⁵⁶ Gandhi *supra* note 253.

²⁵⁷ Tait D. Shanafelt et al, “Burnout and Medical Errors Among American Surgeons” (2010) 251:6 *Annals of surgery* 995 at 997.

²⁵⁸ Gandhi *supra* note 253.

²⁵⁹ Carolyn S. Dewa et al, “An estimate of the cost of burnout on early retirement and reduction in clinical hours of practicing physicians in Canada” (2014) 14:254 *BMC Health Services Research* at 6.

8.3 IMPACT OF THE 2018 BUDGET ON THE MEDICAL PROFESSION

As discussed in detail in Chapter 7, the federal government significantly amended their initial proposal, drastically softening the blow for CCPC owners. The predicted negative consequences for both medical doctors and their patients should seemingly be somewhat mitigated. The CMA acknowledged this, calling the 2018 Budget a “step in the right direction” and it is “encouraged that the government has listened to the concerns expressed by the small business community and introduced changes to its original proposal, confirming that our collective advocacy efforts have resulted in meaningful amendments.”²⁶⁰ The Ontario Medical Association (“OMA”), as well, asserted that the Budget was a “significant improvement” from the original proposals and “ensure[s] that incorporation remains a viable option for most physicians to consider as a vehicle for tax deferral”.²⁶¹ In particular, the “the ultimate result of the changes [the passive investment] is lower and far less punitive than what was previously proposed.”²⁶²

Although the changes contained in the 2018 budget has assuaged some concerns for the healthcare system, Doctors of BC stated that the ultimate changes are “not exactly what we hoped for”.²⁶³ Medical doctors will certainly still be adversely impacted by the CPPC tax reforms. Older doctors will experience minimal impact from the reforms and they have had benefited for many years from their CCPCs. Further, once doctors reach age 65 they can

²⁶⁰ Canadian Medical Association, “Budget 2018: Federal Government's Revisions to CCPC a Step in the Right Direction” (Ottawa: 27 February 2018), online: < <https://www.cma.ca/En/Pages/Budget-2018-Federal-Government%E2%80%99s-Revisions-to-CCPC-a-Step-in-the-Right-Direction.aspx> >.

²⁶¹ Ontario Medical Association, *Federal Budget 2018 – Summary of Proposals for Private Corporations* (Toronto: 2018) at 3.

²⁶² *Ibid.*

²⁶³ Dr. Trina Larsen Soles, “No certainty beyond death and taxes” (Vancouver: Doctors of BC, 2018), online: < <https://www.doctorsofbc.ca/presidents-blog/no-certainty-beyond-death-and-taxes> >.

split income with their spouses without attracting the TOSI. Doctors nearing retirement who have accumulated significant wealth in their CCPCS, however, are more likely to lose access to the small business deductions. Younger and future medical doctors will not see the same tax benefits from CCPCs as their predecessors. Incorporation, however, continues to be a viable financial and tax planning strategy that provides considerable benefits. It is therefore unlikely that the amended CCPC tax reforms will create a drastic adverse impact on the medical profession.

CONCLUSION

The number of CCPCs has grown dramatically over the past several years as an increasing number of people are realizing the tax savings benefits it supplies under the *ITA*.²⁶⁴ Medical doctors, in particular, have seen considerable financial benefits through the use of professional corporations.

In Canada, as in many other countries, taxation is the principle means by which governments exercise control over the economy and meet the needs of their citizens.²⁶⁵ Accordingly, it is crucial to balance creating competitive trade and investment with promoting and supporting essential government revenue.²⁶⁶ There has been significant discussion recently that the correct balance has not been struck in Canada and that it has resulted in tax inequality.²⁶⁷

In response, the Canadian government proposed three major changes to the tax benefits conferred upon CCPCs, as the government asserts that private corporations are being misused and result in high-income earners gaining tax advantages that are unavailable to many Canadians.²⁶⁸ The Department of Finance released a Consultation Paper that suggested adjusting the *ITA* to a) restrict “income sprinkling”, b) reduce the attractiveness of retaining passive investment portfolios in private corporations and c) prevent the

²⁶⁴ Tax Planning Using Private Corporations *supra* note 1 at 11.

²⁶⁵ Robert D. Brown & Jack Mintz, “The Big Picture” in Heather Kerr, Ken McKenzie & Jack Mintz, eds, *Tax Policy in Canada* (Canadian Tax Foundation, 2012) 1:1 at 1:2.

²⁶⁶ *Ibid.*

²⁶⁷ See Tax Planning Using Private Corporations *supra* note 1 for a discussion.

²⁶⁸ *Ibid* at 5.

conversion of business income into capital gains.²⁶⁹ The tax changes are highly complex and there has been widespread outrage and concern about the government's plan, viewing it as an attack on small business.²⁷⁰ There are also many, however, that consider the proposal to be a step in the right direction as it "seems unfair that these benefits are not available to Canadians with similar incomes who cannot incorporate."²⁷¹

In response to the considerable public outcry, the federal government significantly amended the initial reform proposals. The government simplified and clarified the TOSI reforms and did not move forward with the proposed changes to the LCGE rules. It also overhauled its original reforms to the taxation of passive income, not changing the rules regarding passive income tax directly, but rather reducing the small business deduction if passive investment income exceeds \$50,000. The government further decided that it would not move forward on their proposed measures regarding converting income into capital gains.

Many medical doctors regarded the Consultation Paper proposals as an attack, both on their finances and their moral character, and were extremely upset. They felt hurt that they were being labeled tax cheats who did not "pay their fair share". Doctors believed various Provincial Governments reneged on good faith agreements, placing doctors in a unique tax situation, unlike many other business owners. Consequently, it was predicted that the initial

²⁶⁹ *Ibid.*

²⁷⁰ Dubreuil *supra* note 137.

²⁷¹ Colin Perkel, "Dissenting doctors write open letter in support of federal tax reforms" *The Toronto Star* (17 September 2017), online: < <https://www.thestar.com/news/canada/2017/09/17/dissenting-doctors-write-open-letter-in-support-of-federal-tax-reforms.html> >.

CCPC tax reforms would result in brain drain, shorter doctor hours and an inability to attract future doctors. There was also the reasonable belief that due to a shortage of doctors, doctors' health would be negatively impacted.

Finally, it appears that the uproar within the medical community following the release of the Consultation Paper has abated following the significant amendments to the original proposals. Medical doctors are no longer threatening to leave their jurisdictions or retire early in nearly the same numbers they were previously. The impact on doctor health and the ability for provinces to attract doctors is yet to be determined.

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