Tax Simplification for the Owner-Manager

Adam Friedlan

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Adam Friedlan, Friedlan Law

Robert Couzin, in a 1988 article (“Simplification and Reform” (1988) 26:3 *Osgoode Hall Law Journal*), noted that a passage in the 1966 Carter commission report, by then over 20 years old, “exhibits an almost eerie contemporaneity.”

The Carter commission had reviewed, among other things, the two main legislative responses to tax avoidance: specific rules and general rules. The commission noted that specific rules were “responsible for much of the obscurity in the Act” and were often drafted “in tortuous and obscure language of unrivaled complexity and difficulty.” In discussing the history of anti-surplus-stripping rules, the commission also noted that attempts to draft specific rules had “failed and the subsequent amendments to extend or strengthen the legislation were equally unsuccessful, until, ultimately, resort was had to discretionary legislation.”

Today, over 35 years since the publication of Couzin’s article, I too am struck by the “eerie contemporaneity” of the Carter commission’s 1966 remarks. The current tax system is increasingly beset by the problems of both tortuous specific rules and discretionary legislation, with each problem contributing to complexity in its own way.

Commentary on the problem of tax complexity is nothing new. Complexity has been bemoaned for decades, and yet it has only increased. That said, my aim in this article is to set out some ideas for tax simplification that are relevant to owner-manager taxation. I focus on targeted and practical solutions, with two related considerations in mind. First, I recognize that, without a fundamental rewriting of our tax laws, it is unlikely that any efforts to simplify the tax system can escape the dilemmas that plagued earlier efforts. Second, I recognize that any changes fundamental enough to avoid those earlier dilemmas would impose significant transition costs on taxpayers and their advisers.

The Scope of the Problem

Before discussing potential solutions, it is worth delineating the scope of the current problem. The last 10 years have seen very significant legislative changes. These changes and their rapid introduction have created a fundamental mismatch between the complexity of the rules and the ability of the tax profession to cope with them.

To illustrate, the following is a far from complete listing of some of the past decade’s most pertinent changes to

owner-manager taxation:

- the 2015 amendments to section 55,
- the 2016 and 2018 changes to eligibility for the small business deduction,
- the 2018 changes to the "tax on split income" (TOSI) rules,
- the 2022 enhancements to tax reporting for trusts,
- the 2023 amendments to the mandatory disclosure regime (critiqued in the September 2023 issue of *Perspectives*),
- the 2024 amendments to the general anti-avoidance rule (GAAR) (see the March 2024 issue of *Perspectives*),
- the 2024 changes to the alternative minimum tax (AMT), and
- recent measures related to changes to the capital gains inclusion rate announced in the 2024 federal budget.

In my view, the first step for tax simplification in the owner-manager area should be to carefully review these measures to assess whether the complexity they have introduced is justified by their revenue-raising effects. Such a review should attempt to account for the costs of these measures to taxpayers, including both direct costs and any dampening effect on business activity. Measures that cannot be justified after such a review should be modified or repealed. A better balance needs to be struck between the policy objective of preventing loss of revenue and the technical complexity imposed by that objective.

Basic Housekeeping

Aside from revisiting a decade's worth of tax changes, there are workable opportunities for taking advantage of tax simplification; in other words, there is "low-hanging fruit." A careful process of legislative pruning could significantly reduce the amount of legislation required to achieve the same effect.

Owner-manager taxation is burdened by numerous attribution rules, all largely aimed at the same issue. Are all of these overlapping rules really necessary to achieve the desired policy outcomes? Take, for example, the corporate attribution rules (in section 74.4 of the ITA) and the TOSI rules. Both regimes are directed, at least in part, at curtailing income splitting among family members. Do the two regimes reduce income splitting to a degree that justifies the complication of having two sets of rules? How much revenue would the government really lose by consolidating these parallel regimes?

The ITA has also started to exhibit layering effects, with one legislative regime placed on top of another, producing outcomes that are sometimes counterintuitive. The recent amendments to the AMT are a perfect example of this: advisers are sometimes unable to predict a transaction's tax effects without "running the return." This layering of rules produces unpredictable results that often defy intuitive reasoning—a recipe for mistakes, surprises, and unhappy taxpayers. Consideration should be given to determining whether the AMT addbacks could be simplified, rationalized, repealed, or better integrated into the ITA.

The proliferation of incentives should also be carefully examined. For example, does the recently announced Canadian entrepreneurs' incentive justify the additional complexity above and beyond the longstanding capital gains exemption? A consolidation of incentives could significantly reduce the burden both on taxpayers engaged in reasonable tax planning and on the CRA, which currently administers a multiplicity of regimes.

Furthermore, to the extent that tax benefits are made available, they should be reasonably accessible without undue technical complexity if they are to succeed in encouraging the desired behaviour. Incentives that are too complex to understand are likely to fail. To take a current example, some advisers are shying away from making use of the recently revised "intergenerational business transfer" rules (discussed in the September 2024 issue of *Perspectives*). Those rules were introduced to address surplus-stripping concerns arising from previous amendments to section 84.1 introduced by Bill C-208, a private member's bill. However, the approach taken with these rules is so complex that it will significantly hinder taxpayers' ability to access the benefits to which they are entitled.

Finally, the ITA is rife with what I term "traps for the unwary"—simple technical flaws that go unaddressed for years. The case of *Vefghi Holding Corp. v. The King* (2023 TCC 135; under appeal) is an instructive example. The case dealt with the question of whether a payer corporation and a dividend recipient (that received the dividend via an allocation from a trust) were "connected" in the year of sale. Allowing such a relatively straightforward technical issue to remain ambiguous for years ensures unneeded complexity.

Managing Complexity

As an adviser to owner-manager clients, I spend an inordinate amount of time navigating the intricacies of section 55 and the rules applicable to the lifetime capital gains exemption. Preserving the deferral on corporate retained earnings without losing eligibility for the capital gains exemption requires extremely elaborate planning; this is typical of the rampant complexity for which there is no obvious policy justification.

By way of background, in 2015, significant amendments were made to subsection 55(2) in response to the decision in *D&D Livestock Ltd. v. The Queen* (2013 TCC 318). As a result, what had been a relatively mundane issue of dividend payments between related companies relying on the exemption in paragraph 55(3)(a) became an issue of significant uncertainty and complexity. Although the government introduced these amendments because of concerns about potential abuse, it could have made the revised regime in section 55 more targeted by providing meaningful safe harbours for benign transactions. It did not do so, and as a result taxpayers are often forced into awkward and costly "trust sandwich" structures in which (as in *Vefghi*, cited above) a discretionary inter vivos trust is used to flow after-tax profits from an operating company into a corporate beneficiary of that same trust.

It seems to me that if a dividend is paid in cash rather than by the issuance of a promissory note, or by payment in kind, and is not a deemed dividend arising because of an increase in legal stated capital, the concerns raised by *D&D Livestock*-type situations would be significantly reduced. Accordingly, a safe harbour for cash dividends under paragraph 55(3)(a), rather than solely for deemed dividends under subsection 84(3), would have significantly reduced complexity without, in my view, introducing substantial risks of revenue leakage. Attempts to simplify the tax system should aim to confine complexity to situations where it is really required. Expanding the use of clear safe harbours could help achieve this goal.

Another way to address complexity would be to focus on conceptual clarity and the use of relatively clear conditions of application. Take, for example, the amendments to the TOSI rules. Under the pre-2018 version of these rules, taxpayers were generally excluded from their application unless the income in question was received by a child under the age of 18. This is not to say that the old TOSI regime was simple, only that the rules contained an important and understandable demarcation line. Under the amended rules, virtually every mundane dividend paid by a corporation with multiple family members as shareholders must be analyzed for potential TOSI exposure. In the future, the use of simpler legislative design would better balance taxpayers' need for clarity in their everyday transactions and the

government's desire to mitigate revenue leakage.

Minimizing "Greyness"

Another area of significant concern for owner-manager taxpayers is "greyness." Take, for example, the recent amendments to GAAR, which introduced, among other things, a penalty. The new GAAR penalty has only two significant safe harbours: (1) where disclosure is made under section 237.3 or 237.4, and (2) the exception in subsection 245(5.2) under which no penalty applies if, at the time the transaction was entered into, it was reasonable to conclude that GAAR would not apply because the transaction (or series that includes the transaction) was "identical or almost identical" to a transaction or series that was the subject of published administrative guidance or court decisions.

The narrowness of these exceptions means that many transactions could (at least theoretically) be subject to a penalty under GAAR if not disclosed. Taxpayers may choose not to disclose a transaction because of the time, cost, and additional audit risk involved. It is important to note that an audit imposes considerable costs on taxpayers even if the assessment results in no additional tax. In addition, small and medium-sized businesses may lack the resources to bear these kinds of costs. Furthermore, if all routine transactions were disclosed in order to mitigate GAAR penalty risk, the CRA would be overwhelmed.

Taxpayers seeking the protection of the exception in subsection 245(5.2) must consult a growing body of administrative guidance. For example, a taxpayer considering a post mortem pipeline and seeking such protection must comply not only with the requirements of the statute itself but also with CRA positions such as those described in CRA document no. 2023-0987941I7 (February 29, 2024). That document incorporates existing CRA guidance by reference and imposes additional requirements not explicitly grounded in the statute, including a requirement that taxpayers continue the business of the corporation subject to a pipeline transaction for at least one year. The need for taxpayers to refer to a growing body of administrative guidance (itself often unclear or contradictory) adds significant complexity to tax planning.

In my view, the GAAR penalty should be repealed or, failing that, limited to cases where a significant fault element is present. This fault element should go beyond the standard of existing GAAR case law requiring that the abuse be "clear" and should be closer to a gross negligence standard. This change would refocus analysis on legal sources (the statute and the case law) and away from administrative guidance. In general, extra-statutory quasi-law should be avoided because it adds complexity and uncertainty. (See, for example, the CRA guidance on the mandatory disclosure rules, and the recent CRA position paper on "safe income" in section 55.) The solution to overbroad legislation should not be through administrative guidance or relief. The better solution is for the legislation to be more targeted and comprehensible to begin with.

Conclusion

Unfortunately, the problem of complexity cannot be eliminated completely because it arises, in part, from the tension between competing goals of the tax system. However, because the issue of tax complexity has gone unaddressed for so long, there are many opportunities for reform. Far from being dramatic, targeted reforms to address complexity can be implemented without, one hopes, upsetting the apple cart.

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