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Richmond Hill Board of Trade Submission to the Standing Committee on Finance re: Tax planning using Private Corporations

The Richmond Hill Board of Trade is made up of approximately 560 members, over 60% of which have ten or fewer employees and another 8% have 11 to 25 employees. We are the "voice of business" in Richmond Hill. As such, we provide a leadership role in promoting the business interests of our members.

This submission was prepared by our Government Affairs Committee after it requested input from all members. The Government Affairs Committee is made up of local business leaders and economic development experts. It consulted with local accountants to ensure the submission is accurate from a tax perspective. The submission was approved by our Board of Directors and was circulated to all Board of Trade members.

Our members span a broad range of business types, from unincorporated sole proprietors to major multinational corporations. However, the largest segment of our membership is made up of small incorporated businesses. The changes to small business taxation proposed by the government affect a plurality if not a majority of our members and we have heard from many of them that they have grave concerns.

York Region is the sixth largest employment centre in the country. The business segment that employs the largest number of people in York Region are small businesses with fewer than 12 employees. While we do not object to changes that will result in a more fair tax system, we do object to some of the proposed changes for the following reasons:

Complexity

The proposed changes will add complexity, introduce more uncertainty in how the Income Tax Act (the "**Act**") is interpreted and applied, and increase the administrative burden for already overwhelmed small business owners. For the government's part, it will not achieve its goal of simplifying the Act, but will instead increase the challenge for CRA auditors to correctly interpret the rules. These proposals will lead to a significant increase in business uncertainty for independent business owners who already find CRA compliance a significant undertaking.

While we respect the need for integration in tax policy, we believe this is already in place and these changes would instead unfairly increase the burden of middle income independent business owners to levels higher than those affecting other taxpayers. Our members, including many professionals, feel unfairly targeted, intentionally or not, by the changes and painted as "tax cheats" by the federal government simply for accessing tax planning tools they have been encouraged to use for decades.

Many of these policies were put in place by previous Liberal and Conservative governments in order to support the growth of independent business, recognize the challenges and risks inherent in private businesses and reflect the disproportionate burden they face in complying with regulations and accessing financing.

These changes are coming at a time when business owners are already facing many increasing and additional costs, including Canada Pension Plan increases for the next several years, new provincial policies around carbon pricing, increases in minimum wage and labour reforms.

Creating additional business tax uncertainty is particularly unwelcome at a time when lower commodity prices and NAFTA negotiations are already causing stress among many of Canada's entrepreneurs. Furthermore, these proposed changes will restrict the ability of Canadian entrepreneurs to compete internationally against other countries that have more favorable business environments and tax policies.

Effect of the changes on Small Business

Our members have been concerned by the language being used by the government. Our small business owners consider themselves middle class and they have been surprised to see a proposed change to their taxation explained away as only affecting the wealthy. They are not taking advantage of "loop holes" but using the tax system as it was intended to be used.

In fact, our members who are tax accountants have advised that they have clients who make as little as $40,000 a year who will be negatively impacted by the proposed changes. Some members who are not near the top 1% of earners have privately explained their concerns to our committee members. Such people are not only concerned about losing their retirement plans, but they are also concerned about losing the ability to save money in their business for future investment in growth, such as buildings and equipment.

One of the explanations for the proposed changes is that a corporation was not intended to be a retirement plan for its shareholders. First, this is somewhat inaccurate. For more than 40 years it has been common knowledge that this is what many small business owners have been doing. By allowing this investment to continue, the government implicitly approved of such planning and led people to rely on the existing rules. Pulling the rug out from under them at this late stage is neither fair nor reasonable, particularly when a large number of business owners are nearing retirement age.

Secondly, this argument ignores the fact that small business owners, while they may hope to save in their business for retirement, also need to be able to use the funds they have saved for business purposes. In some years, they will need the funds to cover low revenues. In other years, they may need the funds to invest in the business or cover the cost of a parental leave.

Thirdly, the suggestion that small business owners have some sort of advantage when saving for retirement is misplaced. Employees, officers and directors of large corporations can plan for retirement by using stock options and pension plans. Small business owners are able to invest in Individual Pension Plans ("IPPs") that provide them with some of the benefits that employees enjoy. However, most small business owners do not choose this option because IPPs do not allow for early use of the funds to cover a bad year or invest in the business. They also tend to come with much higher fees than other investment options. Ironically, it is only wealthy business owners who will be able to take advantage of this alternative option.

Fourthly, even the options of a personal RRSP or TFSA that employees have are insufficient for small business owners. This is because once the money is taken out of the business, it cannot be brought back into the business without an income tax payment. In the case of a TFSA, the tax is paid as soon as the money is removed. In the case of an RRSP, the tax is paid when it is taken early from the RRSP. Either way, the small business owner will have less money available to cover a rainy day or otherwise invest in the business.

Finally, it is important to note that small business owners are often unable to provide themselves with a stable income, growing with regular raises as they get older. Instead, they tend to have some years that are good and some years that are bad. If they are not allowed to leave money in the corporation to smooth out those ups and downs, then their average tax rate is likely to be higher than an employee who earned the same amount of money over the same period of time in a more predictable manner.

Passive Income

The proposed changes related to retaining passive income in a corporation are based on a flawed premise and the example used to support the government's position is misleading and lacks a full analysis. The example used by the Government compares the marginal tax rate of an employee earning greater than $200,000 per year to conclude that the small business owner has an unfair tax advantage. As noted above, the majority of small business owners earn much less than this and therefore are not in a 50% marginal tax bracket. In a letter written by the Finance Minister and published in the Globe & Mail on September 5, 2017, he noted that the average income level in Canada is approximately $49,000. Anyone with taxable income between $46,000 and $74,000 pays a marginal tax rate of 29.65% on ordinary income, which is not significantly different than the corporate income tax rates of 15% or 26.5% in Ontario, depending whether the business qualifies for the Small Business Deduction.

The Government's example also failed to point out that if this employee deposited her earnings into an RRSP or her employer contributed the income directly to her pension plan, then the employee would have no tax to pay and is able to invest 100% of the income. This is a significant advantage to the employee because the business owner must pay the corporate tax before investing any excess cash. The employee also has an advantage over the small business owner because income from passive investments held in a corporation is not tax-sheltered. All of the income earned in the employee's RRSP or pension plan is tax-sheltered. In the case of pension plans, particularly for government employees, teachers and union members, the pension income is guaranteed. A small business owner has no guarantee relating to the value of the passive investments that they make in their corporation.

The other key point that the Government's example ignores is the fact that even if a small business owner has the same marginal tax rate as the employee, they will have less to contribute to their investment account because they must pay payroll taxes on any salary that they withdraw from their business. If the business owner withdrew $200,000 of salary (to be consistent with the employee used in the Government's example), the business owner would pay $2,564.10 for the employer share of CPP and would pay $3,900 of Employer Health Tax, assuming that they are a business in Ontario, for a total tax cost of almost $6,500.

High income employees, such as the one used in the Government's example, often work for public companies. A portion of their annual employment income, sometimes significant, often comes from stock option benefits, which are taxed at half the normal tax rate, 25% in this example. The employee used in the example may actually be able to save more in their investment account than the small business owner because of this significant tax benefit available to them. Pensioned employees are allowed to split their pension income with spouses to lower their family tax bill. A small business owner will not have this advantage available to them if they use their corporation to save for retirement.

Like everyone else in Canada, business owners need to save for retirement. Unlike employees, they have much more uncertainty with their finances. They do not know from one year to the next what their income will be. Things can go wrong, which are beyond their control, requiring them to invest additional funds into their companies. They often have to pledge personal assets including their homes to support business loans and commitments, such as their commercial lease. Building pools of capital in their corporations makes it easier for them to have personal guarantees and their home removed from security for the business debts.

These pools of capital are needed to cover future business losses, replace equipment and fund expansion, innovation and maternity leaves. Start up companies will have particular difficulty accounting for investments between the time funds are received and the time they are spent. Forcing business owners to withdraw these funds or penalize them with an overall tax rate in excess of 70% is neither logical nor fair.

Neither of the suggested methods are workable. They all add additional administrative burden on the business owners and their employees/professionals in tracking the various pools of funds. For example: capital; funds from passive investment; and funds that were from active business. What happens when funds not immediately needed are invested in passive investments and then are required for business expansion? Is there an acceptable period when assets that are not immediately needed for active business can be invested without the penalizing tax rate? If so, who is to determine "an acceptable period" and what happens if the business plan does not bear out due to factors beyond the business owner's control such as an economic downturn?

Capital Gains

The proposed changes deny what is otherwise an increased cost base of shares acquired from non-arm's length parties under the current rules and treats the amount as taxable dividend. These changes penalize and discourage inter-generational transfer of family businesses, resulting in double taxation, and are retroactive as the proposed rules apply to all non-arm's length transactions including transactions that occurred prior to the announcement date with no grandparenting.

Before the proposed changes, one of the ways that business could be passed from one generation to another is as follows: a business owner, Graham, is in his 70s and is considering selling his restaurant business to his children who are actively involved in the business. He worked out an arrangement where he sells his shares to his children for a promissory note to be paid over ten years. His children would then transfer their shares to a holding company in return for promissory notes. Graham's promissory note would be repaid with after-tax future profits earned by the restaurant which would be paid to the holding company as dividends. Graham would recognize a capital gain (assuming he does not claim any capital gains exemption) over ten years and pay taxes on the gain as he receives the proceeds. Under this scenario, there is one level of tax which is the capital gains tax payable by Graham.

Under the proposed rules, taxable dividends equal to the fair market value of the shares the children acquired will be taxable to the children at the highest rate because the children acquire the shares from a non-arm's length party. In addition, the capital gains realized by Graham is re-characterized as split income taxable at the highest rate all in one year and not over the 10 years under the current rules.

Alternatively, Graham may sell the restaurants to a third party, realize capital gains and avoid all of the issues outlined above including the double taxation.

In the example above, in addition to the double taxation, the proposed rules would apply to reduce the cost base that the children have in the shares they acquired from Graham **even** if Graham sold his shares 20 years ago. This is not fair as these transactions were carried out in the past where the legislation clearly allowed for a different result.

Income Sprinkling

The proposed changes will tax all payments to all individuals at the highest rate where there is a connected individual (someone who has strategic, equity, earning and investment influence over the corporation) unless the payments are determined to be "reasonable" based on labour and capital contributed to the business compared to arm's length transactions.

Furthermore, payments to individuals who are within 18 to 24 years of age are subject to more stringent conditions in that the individual must be "...actively engaged on a regular, continuous and substantial basis in the activities of the business...".

The determination of "reasonableness" is subjective and will lead to many disagreements between taxpayers and CRA resulting in many appeals and litigation.

These proposals ignore the realities of private businesses and add unnecessary complexity and uncertainty by requiring business owners to determine the "reasonableness" of amounts paid to family members who contribute to the business. One of the reasons that private businesses are often referred to as a "family businesses" is that when an entrepreneur opens a business, his or her family is often deeply involved in either formal or informal ways. Family members are often relied on to do "whatever" it takes to keep the business running at any particular time. What is an arm's length reasonable payment for someone to provide anywhere from one hour to an indeterminate period of time so that an unexpected demand may be fulfilled and delivered on time to the customer on short-notice? Will such family members be entitled to minimum payments when they are on call pursuant to new Ontario employment standards?

The comparison of an entrepreneur with a salaried employee is completely inappropriate. Many business owners not only use their family homes as collateral against loans taken to support the business, they also do not have access to safeguards such as employment insurance for job security. When the spouse or children are also involved in the business, the risk is exponentially larger as the entire family runs the risk of losing any means by which to support themselves. And yet, the government believes that applying a prescribed rate is sufficient to compensate for the family's risk of its capital. Would the government be willing to extend loans to private businesses at a prescribed rate?

The additional restriction on payments to 18-24 years old is particularly harsh and discriminates against family members. No such test is needed if the individual works for a third party. In its current form payments to these individuals from a family-owned business will not be taxable at the highest marginal rate only if the individual "actively engaged in a source business on a regular, continuous and substantial basis for the year".

Firstly, we are not sure what this means and how it will be applied. Secondly, this may stop family businesses from employing their children or relatives for less than a full year even if the individuals are paid at fair market rate. Thirdly, people in this age category are mostly in their post-secondary education period and they earn this income to pay for their education costs. Their parents, as small business owners, likely had lower incomes and less ability to save money in an RESP. If the government takes away their opportunity for employment, and/or taxes their income at the highest rate, that would mean they have less to pay for their education. While payment to a spouse may ultimately go to the common household expenses and reduce the tax burden, a payment to an adult child will be for that child to spend as they see fit. With the proposed changes small business owners may well pay more taxes on their own income, but they will also provide less money to their children to spend as they see fit and it is those children without any other source of income who will be most negatively affected.

Conclusion and Recommendation

Based on the above concerns, we make the following recommendations:

> Extend the consultation period to allow all stakeholders sufficient time to understand the proposed changes and provide comments. This government promised evidence based policy and it will not succeed if it proceeds in the timeframe planned.

Ensure that existing structures and investments are grandparented to avoid retroactive effect and delay or gradually implement changes relating to capital gains and passive income for a decade so that older business owners are not penalized for following the rules that haven been in existence for the last 40 years.

To limit complexity, work with stakeholders to come up with changes that address specific concerns while recognizing the different risks between a salaried employee and a business owner, and the real contributions of family members.

To limit the effect on lower income small business owners, while we oppose any new imputed tax rate, if such imputation is to proceed then it should be at the taxpayer's actual rate and not the highest marginal rate.

Leave the passive investment income rules unchanged. The current rules result in perfect integration which means that investment income is taxed at the same overall tax rate (corporate and personal taxes combined) whether it is earned in a corporation or personally. That is the current premise of the Canadian tax system. We do not understand why this premise should be changed. If a limit must be imposed, then the limit should be sufficient to avoid the problems above and not based on an arbitrary number of years of income, which would lead to a limit that goes up and down over time.

For capital gains:

> The proposed rules need to be reworked so that private corporation owners are not penalized for selling their business to family members instead of a third party.
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> Private business owners should not be penalized for having proactively structured their affairs for asset protection and estate planning purposes.
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> The legislative changes should not be retroactive.

Any changes to the rules regarding income splitting should allow for family members to work in a family business part time or on a seasonal basis. They should also ascribe value to any equity risked by the family, such as personally guaranteeing a business loan or risking the family home. The changes should also avoid penalizing true financial transactions where the person receiving the money can spend it as they please and does not contribute to the family budget.

The Richmond Hill Board of Trade believes that the above recommendations will improve the government's proposed changes. While we support tax fairness, we do not believe that small businesses should suffer in order to limit the misuse of existing rules by those who were not intended to use them. This would not only be unfair to hard working middle class Canadians, but it would be detrimental to our economy and the government's bottom line in the long run.

In order to make our case more helpfully and answer questions, we also request an opportunity to appear before any Parliamentary committee that is reviewing the proposed tax changes.

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