THE CANADIAN CHAMBER OF COMMERCE | LA CHAMBRE DE COMMERCE DU CANADA

Submission to Finance Canada
Tax Planning Using Private Corporations

From the

Canadian Chamber of Commerce

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Submitted by:

Hendrik Brakel

hbrakel@chamber.ca

"Watch out for the tax guys. They'll come to see you and present some loophole in existing law and/or enforcement policy that people are exploiting, and try to convince you that this or that loophole needs to be shut down. Once you agree that the practice in question seems to require some legislative correction and authorize them to spend time and resources on it, they will come back to you with a massive overkill in their solution, sideswiping hundreds or even thousands of parties who were never taking advantage of the system."

– Simon Reisman, Former Deputy Minister of Finance, as quoted by Stanley Hartt, another former Deputy Minister of Finance
  Can be viewed at: http://policyoptions.irpp.org/magazines/september-2017/the-flaws-in-a-one-size-fits-all-approach-to-tax-policy/)

Executive Summary

At the Annual General Meeting of the Canadian Chamber of Commerce from September 23 to 25, we heard from hundreds of chambers from across the country that the number one issue, really the only issue that our members are worried about, are the finance department's proposed tax changes. Our members have never been so motivated, so angered by federal policy and they are urgently demanding that the government put its proposals on hold in order to have genuine consultations. The negative reaction from business is because the proposed changes are so broad, far-reaching and with unintended consequences.

The government has proposed the most radical changes in 50 years, including (1) a new tax (effectively 65%-73%) on investment income in a corporation, (2) tough new scrutiny and a much higher tax rate for compensation in a family business deemed "unreasonable," and (3) new, far more restrictive rules for converting income to capital gains that will make it costly to pass family businesses on to the next generation.

This will have a harmful impact on the middle class. Two thirds of small business owners earn less than $73K and half of those earn less than $33K. They also employ large numbers of Canadians: there are 11.2 million people who work in the private sector and 8.2 million (70%) work for small businesses.

We believe the tax changes will:

- Unfairly prevent business owners from building up retirement savings;
- Lead to lower savings within their businesses, eroding sustainability and future investment for business growth;
- Make it more difficult to pass down ownership of family-run businesses to the next generation;
- Result in more intrusive, costly audits by CRA;
- Discourage entrepreneurship;
- Reduce venture capital available to Canadian business;
- And send foreign investors away to friendlier markets; and
- Reduce economic growth and job creation in Canada.

We are urging the government to:

- Take these proposals off the table.
- Launch meaningful consultations with the business community to address any shortcomings in tax policy without unfairly targeting businesses.
- Establish a royal commission to undertake a comprehensive review of taxing statutes guided by the principles of simplification and modernization, as well as having the goal of reducing compliance costs to make Canada a competitive tax regime once again.

The Government's Consultations—Why 70 Days Is Not Enough

The Government's proposed policy is a massive overkill in response to a perceived injustice. It is as though the finance department crafted tax measures that would affect the maximum number of businesses, in the most complicated manner, and not collect very much revenue. The expected $250 million from income sprinkling is barely 1% of the deficit.

There is not a restaurant or a farm in the country that does not have family members working there. Almost every business in Canada has passive income, savings stashed away and earning a modest return, unless they are on the brink of bankruptcy. These people will be affected either by tough new scrutiny of wages and dividends paid to family members, or they will face a much higher tax in investment income.

The consultations so far have proven to be frustrating. Each time the Canadian Chamber or our business members bring forward an example of how business is impacted by the changes, we are told that no, we are incorrect, because the government's intention is not to impact business and that only "high income earners" will be affected. The Government and the Minister complain that there is misinformation and misunderstanding. But when we cite the big accounting firms – EY, Deloitte, BDO, indeed one could cite any firm in the country – we are told that accountants have to be taken with a grain of salt because they advise clients to incorporate for the tax advantages. The Government's messaging so far is to say, "we're listening, but the chambers, the businesses, and the accountants are mostly wrong because they don't understand the tax proposals."

Secondly, business owners are angry about the government's vilification of legitimate small business entrepreneurs as wealthy fat-cats behaving unfairly. At our AGM, the CEO of the Saskatchewan chamber said that the Minister owes the Canadian business community an apology. We also reject the language that the government are using. Passive income is not a "loophole". It's the way Canadian taxation has worked since 1973. No government in any advanced economy has sought to tax it in this manner.

Finally, we object to the "stealthy" approach the government has taken to consultation. The CEO of the Canadian Chamber of Commerce Perrin Beatty said a few weeks ago that a 70-day consultation in the middle of the summer is not a consultation, it's a sneak attack. We believe that the radical nature of the tax proposals and their widespread impacts merit a thorough review and study. It is worth taking the time to get it right.

Unfortunately, the Minister's public remarks, as well as our discussions with Finance officials and the fact that the tax proposals contained draft legislation, all indicated the government intended to proceed with the changes irrespective of what it heard in consultation. That is why we launched a campaign asking chambers and businesses to call and email their members of parliament. We formed a coalition with 70 other business associations calling on the government to put the tax proposals on hold so we could have a more thorough review of the tax policy.

Broad Issues—Why We Need a More Thorough Review of Canada's Tax System

We certainly endorse the government's objective of improving tax fairness. There is no one in the Chamber community that supports loopholes or tax evasion. But the system contains strong incentives because of the way it is designed.

Because of decisions made by governments over many years, personal income tax rates are much higher than corporate rates. This is a normal feature of OECD tax systems. All corporate tax does entails a double taxation, where the government taxes a corporation once when income is earned and again when it is transferred to owners as dividends, so lower rates can alleviate this. More importantly, low corporate tax rates have proved effective at stimulating business activity, hiring, and attracting foreign investment.

However, Canada's differential between personal income tax rates and corporate income tax is among the highest in the western world. The top marginal tax rate in Ontario is 53.5% (on income over $220K), while a CCPC would pay just 15% on income less than $500K. A gap of almost 40% is clearly problematic.

But rather than bringing in new administrative burdens on all corporations, a broader discussion about the top marginal rates, whether rates above 50% cause disincentives or provoke venture capitalists to leave Canada. There is much research into the effects of varying corporate tax rates that could be fruitful.

The second broader discussion around tax fairness is whether business owners deserve treatment that is different than employees. The Finance Department's consultation document contains lengthy examples which pit employees against business owners to demand why the latter should receive "advantages". We believe that the comparison is entirely inappropriate. Unlike an employee, a business owner doesn't get a pension or health benefits or vacation pay. She invested her own money to get the business started. Or, she pledged her personal assets (house, car) as collateral for a loan. She has employees who depend on her. And, if nobody wants her goods or services next month, she does not earn a penny.

In addition, many business owners may need help with retirement savings. Many businesses incur losses in their start up years that the shareholder cannot use to offset personal income. Innovation, job creation, competitiveness all depend on entrepreneurs to risk their life savings to start a new idea. Instead of punishing them for not being employees, government officials who worry about growth should be striving to make life easier for those people.

SOLUTION

Establish a royal commission to undertake a comprehensive review of taxing statutes guided by the principles of simplification and modernization, as well as having the goal of reducing compliance costs to make Canada a competitive tax regime once again.

Income Splitting

Far from being a sinful outrage, the Government has gone back and forth on income splitting. It is apparently fine for seniors who can split income from a company pension plan, RRSP or RRIF with spouse. In 2014, the previous government allowed up to $50K to be split by people with children, but in 2016 the current government reversed policy on income splitting. We understand the government's concerns about income splitting as a strategy to reduce taxes.

However, the proposed cure may be worse than the illness because the nature of families and family business is such a complex issue. Put simply, even when a spouse has never set foot in the business, it may be entirely legitimate to split income based on the property rights and labour contribution. Firstly, the spouse's personal assets are on the hook in a family business, where the business owner signs a general security agreement or pledges the house, car, and family savings as collateral. These can be seized if the business fails.

Secondly, if one spouse is working 12 hours a day in a business, the other spouse has to pick up the slack at home. This sacrifice has value to society and is as critical to business success as a direct contribution from an employee. The famous Carter commission from 1966 strongly recommended the family unit be the appropriate taxing unit: "We believe firmly that the family is today, as it has been for many centuries, the basic economic unit in society."

The most challenging problem around the proposed measures on income sprinkling are of a practical nature, particularly around "reasonableness" tests. A small business spouse does a variety of tasks: meeting customers, helping with reports, answering phones, general advice and problem solving, book-keeping, quality control. What is the reasonable salary for such a person?

We are also concerned about the government unleashing an army of auditors. If the Government expects to raise $250 million by applying a higher tax rate on "unreasonable" compensation of family members, this would require CRA to tax $1 billion of salaries/dividends and audit hundreds of thousands of businesses. If a spouse is paid $70K, but CRA assesses the value of his/her labour at $40K, how should a business owner prove the value of the contribution?

The reasonableness tests for dividends are even more complex. A dividend payment would be considered reasonable if it does not exceed the amount that would be paid to a non-arms length party for a similar risk, capital contribution or labour contribution. If a family member invests in a bakery in Halifax, what is a "reasonable" rate of return for the capital and risk? Should we look at the ROI of similar Nova Scotian bakeries, or SMEs in the Atlantic Region, or the success rate of first-time entrepreneurs? Also, why can investors earn generous returns from public companies, but private companies require a reasonable labour or capital contribution? We worry that the government will discourage investment in corporations because overly generous dividends might trigger a higher rate of taxation under new rules.

Finally, the new requirements for a labour contribution also could have perverse results. Imagine a couple that owns a restaurant for 30 years and pays themselves $50K annually in dividends. If one spouse reduces her hours worked because of aging, she could trigger a higher tax rate because of reduced labour contribution. This would not happen if instead they had invested in a RRIF.

SOLUTIONS

1. To reduce administrative burden around reasonableness tests, CRA should be directed to accept as evidence signed affidavits from business owners that attest to the duties and value of the work performed by spouse or children.
2. Expand TOSI rules only to adult family members age 18 to 24.
3. Clarify that expanded TOSI rules do not apply to salaries.
4. Introduce a de minimis (e.g. $50K) for spousal dividend payments that will not trigger scrutiny and higher tax rates
5. Provide technical notes that clarify generous rates of return (40-50%) are appropriate for SMEs and venture capital investments.
6. Undertake a gender analysis to ensure that women are not disproportionately disadvantaged by the proposed income splitting measures.
7. Launch meaningful consultations with the business community to ensure that income sprinkling rules do not unfairly impact legitimate family businesses.

Taxing Passive (investment) Income

This is the tax proposal that the Canadian business community is most worried about. Almost every business in Canada has passive income, some savings stashed away and earning a modest return, unless they are on the brink of bankruptcy.

Business owners generally invest their life savings in the business. So they don't have a separate retirement account. They accumulate the surplus of funds that can be used to get them through economic downturns or for capital investment. As one owner told us, "I keep most of the earnings in the company because we're trying to grow and in construction, we go through tough cycles when business dries up.

Investment income is already taxed at a rate of 50.3%, which is refundable when a shareholder receives the income because she will be paying personal tax rates. If the tax becomes non-refundable and then personal taxes are applied on top, then the effective tax rate becomes 65% to 73%.

If the government hits investment income with a 73% tax, business owners won't have any incentive to keep surplus assets in the business. Most will be better off taking money out of the business, perhaps paying themselves a higher salary in order to max out RRSPs.

This means less investment, less jobs, and less of a cushion to make it through a downturn.

It would also mean less productivity. There is a Bank of Canada study called “Productivity in Canada: Does firm size matter?” which found that half the productivity gap between companies in the United States and Canada was because Canadian businesses are smaller and smaller companies invest less in capital and skills. This tax would cause them to invest even less.

Next, imagine a venture capitalist who specializes in green technologies. She takes equity positions in start up companies that are trying to commercialize environmental tech. But those investments are passive income according to the definition. So she could be hit with a 60% or 70% tax on those investments.

Successful businesses (particularly in the high-tech sector) use retained profits in the corporation to invest in other start-ups (angel funding). Such investments carry a high level of risk and punitive levels of taxation will reduce an important source of financing for new firms.

Even if a business owner wants to pull the money out, she may not be able to. Many business that are financed have debt arrangements that require a fixed amount of retained earnings to be left in the corporation, or limit the amount that can be distributed to the shareholders.

Finally, imagine trying to explain all this to a foreign investor. The apportionment method of taxing passive income, requires you to allocate income into three pools, plus a pool for shareholder contributions in order to attribute varying after tax rates. The complexity is mind boggling and this is the simplest method described in the consultation document. Most investors to go to the United States.

As a result of this proposal, Canada would have less jobs, less investment, less of the cushion to get us through an economic downturn, less venture-capital, and less foreign investment. The Canadian Chamber of Commerce has been around for many years and we have seen some bad ideas. But this one is a doozy.

SOLUTION

Scrap the idea of taxing passive income because it is too complex, too problematic, too much of a disincentive to save and would send foreign investors fleeing to the US.

Capital gains rules and Intergenerational transfers

The proposed tax changes on capital gains will have a significant impact on intergenerational transfers of business, regardless of income level. We have heard for many years that family businesses may be forced to sell the business to non-family members (where it is treated as a capital gain) as opposed selling to a family member (where it is treated as a dividend). The current proposals make family transfers even more difficult by prohibiting certain structures. As a result, the tax bill for an intergenerational transfer that results from the death of the owner will effectively increase by as much as 70%. The current capital gains rate on death of 24-27% would increase to an effective dividend rate between 40-46%.

SOLUTION

1. The proposed legislation should explicitly rule out double taxation, not just in death but in all cases.
2. Create new rules that allow intergenerational family transfers with minimal taxation.
3. Launch meaningful consultations with the business community to ensure fairness in taxation of family businesses.