SASKATCHEWAN CHAMBER OF COMMERCE

ISSUE IN FOCUS
Taxation

Proposed Changes to the Taxation of Private Corporations in Canada

CORE ISSUE

The Federal Department of Finance is considering major changes to how private corporations are taxed in Canada. Ottawa has taken the stance that all income is equal from a taxation perspective and has failed to accurately recognize the unique and important role played by private investment in business and how those businesses are recognized by the current tax system. The changes proposed will impact tens of thousands of businesses negatively by raising taxes, reducing the incentive for private investment, increasing the administrative burden, and creating additional challenges to the inter-generational transfer of business shares to family members. The changes have been advanced to eliminate perceived loopholes when in fact they were fair and balanced tax regulations that promoted growth in private investment across the county in all sectors. The Saskatchewan Chamber of Commerce must use its full resources to correct these misperceptions and work to change the intended actions of the Government of Canada, or risk seeing a dramatic drop of private sector investment in Saskatchewan.

The unintended consequence of these proposed tax changes mean that small business owners will be significantly worse off as a result.

BACKGROUND

On July 18, 2017 the Federal Minister of Finance, Bill Morneau unveiled draft legislation that was intended to make changes to the *Income Tax Act* and deal with tax planning strategies related to the use of private corporations[i]. Accompanying Minister Morneau's announcement was the release of the discussion paper, *Tax Planning Using Private Corporations* released by the Federal Department of Finance. The tone of the discussion paper centers squarely around the concept of "tax fairness" for the middle class[ii]. For the Government of Canada, these actions are a part of a larger effort to improve the "fairness" of the tax system by cracking down on tax avoidance and the underground economy[iii]. The Federal Government has launched a very short 75-day consultation period with stakeholders that is set to expire October 2, 2017.

In Federal Budget 2017, the Liberal Government signaled its intention to address tax planning strategies being utilized by private corporations that can result in high-income individuals receiving favourable tax treatment not afforded to other Canadians. In recent years, there has been significant growth in the use of professional corporations, with many non-salaried individuals taking advantage of the growing spread between the top marginal personal income tax rate (51.6% in 2017) and the small business rate, which is now at a 37 percentage point differential[iv].

The Federal Government is looking to recoup at least $250 million a year from high-income individuals who use private corporations to reduce their tax burden[v]. It is estimated that 300,000 corporations will be affected by the proposed changes to passive investment income and that 50,000 families nationwide utilize "income sprinkling" to reduce their tax bill[vi]. While the proposed amendments are aimed primarily at the top 1% of earners, the changes would apply to **all** private corporations in Canada, many of which are small and medium-sized enterprises (SMEs), like family-owned businesses. Far from being the wealthy top 1% of earners, small business owners are overwhelmingly middle class and in-fact employ much of the middle class. The unintended consequences of these proposed tax changes mean that small business owners will be significantly worse off as a result.

The Liberal Government's pledge made during the 2015 election to reduce the small business tax rate even further down to 9% currently remains unfulfilled.

CANADA'S CURRENT TAX SYSTEM AT A GLANCE

Canada currently enjoys a highly competitive tax regime compared to its G7 peers on both general and small business tax rates with among the lowest tax costs[vii]. Canada's low business tax rates confer a strong competitive advantage that incent businesses to expand, create jobs, and innovate. Since 2000, the Federal general corporate income tax (CIT) rate was nearly cut in half from 29.12% to its present rate of 15%. Canada's combined federal-provincial general CIT rate of 26.7% (weighted average) is the second lowest in the G7 with the federal portion of Canada's general CIT rate being 12.2 points lower than the US[viii]. The provinces and territories have cut their own general CIT rates from 13.3% to 11.7% (weighted average) as well.

Furthermore, the federal portion of Canada's small business corporate income tax rate has been reduced from 13.12% in 2000 to 10.5% as of 2017. There were increases over the years to the amount of income eligible for the small business tax rate - $200,000 in 2003 to the present-day level of $500,000. Moreover, Canada's combined federal-provincial small business tax rate of 14.4% (weighted average) is the lowest in the G7 and fourth lowest among the OECD countries. Most provinces and territories have followed suit and lowered their small business tax rates as well. The lower tax rate on the first $500,000 of active business income has been critical to the success of smaller firms[ix]. The Liberal Government's pledge made during the 2015 election to reduce the small business tax rate even further down to 9% currently remains unfulfilled[x].

The basic structure of Canada's existing federal tax regime has been in place since 1972. The number of Canadian-controlled Private Corporations (CCPCs) has increased from 1.2 million in 2001 to 1.8 million in 2014[xi]. CCPCs currently account for more than twice the share of taxable active business income than they did in the early 2000s relative to GDP[xii]. The growth of CCPCs has been especially strong among professional services, like doctors, lawyers, and accountants. A number of self-employed individuals – many of whom have typically been unincorporated, are now choosing to incorporate instead. The growing gap between corporate and personal income tax rates has increased the rewards associated with tax planning[xiii].

PROPOSED CHANGES TO TAX PLANNING STRATEGIES

The proposed changes outlined in the *Tax Planning Using Private Corporations* discussion paper can be grouped under the following three strategies:

- Income Sprinkling
- Passive Investment Income in a Private Corporation
- Converting Regular Income into Capital Gains

Income Sprinkling

Income sprinkling is an arrangement where corporate income from an individual facing a higher personal income tax rate is diverted to family members who are subject to a lower personal tax rate or who may not even be taxable at all. Income sprinkling describes a range of tax planning arrangements that result in income that, in the absence of the particular arrangement would have been taxed as income of a high-income individual, but is instead being taxed as income from a lower income individual[xiv]. The tax benefits increase with income and with the number of family members who can receive the sprinkled income. A common and currently legal example includes the direction of a corporate dividend to a child (presumably subject to a lower tax rate) over the age of 18. This is often, but not always, done as a method of payment for post-secondary tuition[xv].

The current income tax system has rules in place to curtail the use of income sprinkling. For example, there is a special **Tax on Split Incomes** (TOSI) set out in the *Income Tax Act* that addresses the sprinkling of income to minor children under the age of 18. In situations where the TOSI (also known as the "kiddie tax") applies, the income derived is subject to the highest marginal personal income tax rate. Minors receiving dividends are also subject to a *reasonableness test* that states that only "reasonable" amounts can be deducted when a corporation or other business owner pays a salary, management fee, outlay, or expense that benefits another person, including a family member. To be considered reasonable, it cannot exceed what would have been otherwise paid to a third-party for the same activities. This provision is rather vague and open to interpretation.

The Federal Government is proposing to extend the existing TOSI for minors to apply to adults in certain circumstances. The draft legislation also proposes to expand upon what is subject to the TOSI, including interest on loans, capital gains if the income would have been subject to a higher rate, and second-generation income if it is earned on income that was itself subject to a higher rate[xvi]. Dividends and other amounts received from a business by an adult family member of the principal business may be subject to a *reasonableness test* that will apply to everyone, but is stricter for those 18 to 24 years of age. The test will be based on the contributions made by the family member to the business and will factor in such things as labour and capital contributions, previous remuneration, and whether or not the person is a "connected individual."

Another proposed amendment related to income sprinkling measures concerns restricting access to the **Lifetime Capital Gains Exemption** (LCGE). The LCGE is important to business owners as it allows them to shield a lifetime, indexed amount of capital gains ($835,714 in 2017) from taxation on the sale of a qualified small business corporation (QCBC). Historically a family could multiply the LCGE amount among members of a family through a family-held trust. For a family of five, this would mean boosting the total LCGE amount to $4,178,570[xvii]. The Federal Government's discussion paper pledges to do away with the multiplication of the LCGE. The denial of the LCGE with respect to split income also means that a capital gain that is not considered reasonable (based on the criteria outlined in the *reasonableness test* described above) will not be eligible for the LCGE. In other words, any capital gains from family trusts or on shares held by minors will no longer qualify for the deduction.

Incorporated Business Owner vs. Salaried Employee: A More Accurate Comparison

The Federal Department of Finance discussion paper, *Tax Planning Using Private Corporations* illustrates a hypothetical comparison between two neighbours - Jonah, an incorporated business owner, and Susan, a salaried employee. In the example, both Jonah and Susan make an annual income of $220,000, but Susan pays about $35,000 more in taxes than Jonah does. While on the surface this may appear unfair, what the example fails to articulate is that Jonah's higher take home pay is balanced against the additional risk he assumes as a business owner.

Salaried Employee: Susan Annual income of $220,000	Incorporated Business Owner: Jonah Annual income of $220,000
Guarantee of regular income	Variable income not guaranteed
High-level of job security	No job security
Does not assume personal liability or risk their capital	Must assume personal liability on business debts/ obligations
Pays half the cost of CPP (employee contribution)	Pays entire cost of CPP (employee and employer contributions)
Eligible for EI coverage	Not eligible for EI coverage
High likelihood of paid sick leave	No paid sick leave
High likelihood of having an employer paid pension plan (usually equal to about 65% of the ten best average years of income)	No employer sponsored pension plan
Three weeks paid vacation (SK full-time employees)	No paid vacation days
Paid statutory holidays	No paid statutory holidays
Legislated standard work hours with overtime or time in lieu for additional hours worked	No standard hours, no overtime pay, no time in lieu, often works more than 40 hours a week
Enjoys robust labour protections	Does not enjoy robust labour protections

Note: This comparison has been adapted from Certified Financial Planner Tim Paziuk's example featured in his article "Look at the Numbers: There's No Justifying a Tax Hike on Employers" published online in the August 21, 2017 edition of The Huffington Post.

Passive Investment Income in a Private Corporation

Private corporations can earn active business income, which is income from the day-to-day operations of a business and through passive income, which is income derived from portfolio investments. Generally, corporate income is taxed at a lower rate than personal income, which can leave a business with more money to invest in their business. Because the income is being taxed at a lower rate, a private corporation has more capital left over to invest in passive investments, which in turn may generate higher return on such investments. As a result, these returns can "compound" over time. The Federal Government presently views this as unfair as shareholders of a private corporation may achieve significantly greater returns on their passive investments held through a corporation than they otherwise would if they had held those same investments personally.

The Federal Government has argued that the lower rates available to private corporations were intended to promote investment back into the business and not to be used as a shielded personal savings account. The proposals contained in the Federal Department of Finance discussion paper would eliminate the tax deferral advantages on passive income earned through a private corporation. Specifically, the Government of Canada is considering a tax regime that would maintain tax rates on passive income equal to top personal income tax rates. Dividend income derived from publicly-traded stocks would no longer be treated as an eligible dividend (subject to a preferred tax rate) and would be reclassified as a non-eligible dividend (subject to a higher rate of tax).

Since the current rules do not consider *the source* of earnings used to fund passive investments through a private corporation, the Federal Government is proposing a way that would apportion corporate passive investment income into three categories or pools that would be tracked from year to year. The three income pools include (i) Income taxed at the small business rate (ii) Income taxed at the general corporate rate, and (iii) Income comprised of amounts contributed by share-holders from income taxed at personal rates[xviii]. This means that there would be three possible tax treatments for passive investment income when distributed to shareholders as dividends. The **Apportionment Method** being proposed would add tremendous administrative complexity to the tax system and would increase compliance costs for businesses.

The other proposal being discussed is referred to as the **Elective Method**. Under the Elective Method, passive income in a private corporation would be subject to a default tax treatment unless selected otherwise. Under the default tax treatment choice, passive investment income contained in a CCPC would be subject to non-refundable taxes, which is generally equivalent to the highest marginal tax rate. Dividends distributed from such an income source would be treated as non-eligible dividends, unless the corporation chose to forgo its small business income tax reduction (10.5% on the first $500,000 of active business income) to treat the dividend as eligible and thus be taxed at a lower rate[xix]. Regarding this proposal, there has been no effective date mentioned and the Federal Government has requested feedback on this. Also worth noting is if the proposed rule changes surrounding passive investment income in a private corporation end up being implemented, this could result in **businesses paying an effective tax rate of about 70% on investment income.**

Converting Regular Income into Capital Gains
Income is normally paid out of a private corporation in the form of a salary or dividend that is taxed at the owner's personal income tax rate. When a business is sold, it is taxed as a capital gain where only one-half of the gain is included in income. This results in a significantly lower tax rate when income is converted from dividends to capital gains. Because of this tax spread, business owners will modify their regular stream of income (dividends and salaries) into capital gains as the untaxed portion of the gain is paid out tax-free to the shareholder. This can be accomplished by using a complex set of steps whereby a company will sell shares to another company related to the shareholder[xx]. There is currently anti-avoidance rules that deal with transactions among related parties aimed at converting dividends and salaries into lower-taxed capital gains but the rule is being circumvented in practice.

The Federal Government is looking to amend Section 84.1 of the *Income Tax Act* to prevent tax planning that circumvents specific tax rules meant to prevent the conversion of a private corporation's surplus into lower-taxed capital gains. The new rule prevents the untaxed portion of a realized gain from being included in a capital dividend account. Future amounts received by the person would be reclassified as dividends and subject to the higher dividend rate. Moreover, these proposed changes also bring with it significant estate tax issues. For example, if an entrepreneur were to pass away, they would have to pay taxes on the value of any private corporation shares. When the estate and its beneficiaries eventually take money or assets out of the corporation, this becomes a dividend and is taxed again. This effectively constitutes double tax-ation and is unfair to businesses. This change eliminates one of the tax planning options available, while the only other remaining option has a strict timeframe and is limited in terms of who can use it.

As a consequence, the effective tax rate on a sale of business assets by a private corporation to a related person would be higher than if those assets were sold to a third-party. The Federal Government is cognizant of the fact that these changes might pose problems for the inter-generational transfer of corporate shares to family members for succession planning and is amendable to more favourable treatment for "genuine" family business transfers but no further details have been released as of yet.

CONCLUSIONS

The proposed changes outlined in the Federal Department of Finance discussion paper create significant challenges for businesses – both large and small. The changes outlined in the discussion paper are unnecessarily broad, unworkably complex, and are disproportionately harmful to small businesses – most of which employ the middle class and are middle class themselves. Discussed below are the many criticisms and shortcomings of the drafted legislation as it is currently written.

Divide and Conquer: Entrepreneurs vs. Salaried Employees
As was referenced earlier in the sidebar and table comparison on page 5 of this report, the hypothetical example outlined in the Federal Department of Finance discussion paper comparing the after-tax income of a salaried employee and an incorporated business owner, both earning $220,000 in 2017 is thoroughly misleading. The additional analysis provided in the side-by-side comparison chart goes beyond the simplistic assumptions made by the Federal Department of Finance and provides some much-needed context as to *why* the incorporated business owner in the example realizes additional after-tax income. Once the analysis from the sidebar is factored in, it becomes evident that comparing a salaried employee to an incorporated business owner is like comparing apples to oranges. Furthermore, the Federal Department of Finance's hypothetical example seeks to portray incorporated business owners as "tax cheats" and promotes an adversarial "us versus them" public policy environment that is highly divisive. The Chamber maintains that the tax planning strategies currently available to incorporated business owners should be maintained going forward, as it is an acknowledgement of the risks that entrepreneurs take.

RECOMMENDATION #1
THAT THE FEDERAL GOVERNMENT PROVIDE A MORE ACCURATE & TRUTHFUL COMPARISON THAT WILL INFORM A FULL-SCALE IMPACT ANALYSIS OF THE PROPOSED CHANGES

Timeline for Consultations
Despite the fact that these proposed tax changes are the most sweeping in the past 50 years, the Federal Government is only offering a 75-day window to consult. Such an important issue lends itself to at least a year-long consultation period or more. The timeline being proposed is wholly inadequate, given the impact of the proposed changes. Not only is the 75-day consultation period too short, but the fact that Minister Morneau's announcement was made during the middle of the summer and accompanied draft legislation suggests that the Department of Finance Canada never intended to have a robust conversation over the merits of the proposed changes in the first place.

RECOMMENDATION #2
THAT THE FEDERAL GOVERNMENT EXTEND THE STAKEHOLDER CONSULTATION PERIOD TO MARCH 31, 2018

Increased Administrative Complexity and Compliance Costs for Businesses
Some of the proposed changes, including the expansion of the *reasonableness test* in the context of the TOSI being applied to adults 18 to 24 years of age add needless bureaucratic complexity to an already complex tax system. Specifically, the various factors contained within the parameters of the proposed *reasonableness test* are vague and subject to interpretation. The same can be said about the Apportionment Method being proposed with respect to passive investment income. Under this proposal, businesses will have to adhere to more detailed record keeping requirements as different types of corporate income would have to be tracked separately. The time spent tracking separate income pools is time that could be better spent working on pressing business matters. Targeting certain segments of the taxpayer population on the basis of factors unconnected to their own compliance is harmful and undermines business confidence.

RECOMMENDATION #3
THAT THE FEDERAL GOVERNMENT COMPLETE AN EXTERNAL REVIEW ON THE ADMINISTRATIVE IMPACTS OF ANY CHANGES BEFORE IMPLEMENTATION

Limited Access to Tax Planning Vehicles
The proposed changes to passive investment income in a corporation will significantly impact a business owner's ability to build up capital for future expansion or to save enough to be able to weather downturns in the business cycle. Passive investment income acts as a necessary hedge against economic uncertainty. The proposed changes also negatively distort the market for business owners seeking to sell their businesses, including ways that may effectively take away their capital gains exemptions[xxi]. Purchasers will be further incentivized to buy assets, in lieu of shares. Moreover, using corporations and family trusts to facilitate the tax-deferred inter-generational transfer of corporation shares to a family member is a key component of prudent business succession planning. The changes being proposed would make selling shares in a corporation or trust to family members prohibitively expensive.

RECOMMENDATION #4
THAT THE FEDERAL GOVERNMENT COMPLETE A DETAILED FINANCIAL AND ECONOMIC ANALYSIS ON THE IMPACTS OF THE PROPOSED CHANGES AS THEY RELATE TO FAMILY-OWNED BUSINESSES

NEXT STEPS

The Saskatchewan Chamber of Commerce has communicated to the Federal Government its disappointment and list of concerns with the proposed rule changes. The Chamber is also encouraging its members to write to the Federal Minister of Finance, the Honourable Bill Morneau and the Federal Minister from Saskatchewan, the Honourable Ralph Goodale to express their apprehensions, as well as take part in the Saskatchewan Chamber petition. In addition, the Chamber will be meeting with representatives from the Federal Government to express its concerns and to ensure that the Federal Department of Finance fully understand the negative outcomes that the proposed tax changes would create. Taxes when fairly applied, are part and parcel of doing business and the business community acknowledges that they have an obligation to pay for the provision of public goods and services that make doing business possible in the first place. Given the fact that these proposed changes to the *Income Tax Act* are the most extensive in 50 years, an ill-informed view of taxation is not conducive to good public policy.

Joshua Kurkjian is the Director of Research and Policy Development with the Saskatchewan Chamber of Commerce

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xiv McKercher LLP. Understanding the Implications of the Recent White Paper on Changes to the Taxation of Private Corporations in Canada. by Joseph A. Gill,

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SASKATCHEWAN
CHAMBER *of* COMMERCE

Saskatchewan Chamber of Commerce
Phone: (306) 352.2671
1630-1920 Broad Street, Regina SK S4P 3V2
www.saskchamber.com