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October 2, 2017

Department of Finance
Via Email

Re: Consultation on Tax Planning Using Private Corporations

Dear Sir or Madame:

We are writing for the purpose of submitting our comments on the recent proposed tax changes related to private corporations which were contained in the paper released by the Department of Finance on July 18, 2017. We would like to begin our comments by condemning the offensive rhetoric contained in the July 18 paper and the related communications from the Department of Finance. Terms such as “tax loopholes” and the implication that hard working small business owners, who are following well established tax rules, are not “paying their fair share” was extremely offensive to a very large portion of the Canadian small business community.

We believe that these proposals, as currently drafted, are far too complex and far too broad in scope and will have a substantial negative effect on small business across Canada – regardless of the level of income. The Minister of Finance, the Prime Minister and others in Government have stated repeatedly that these measures are aimed at “the rich”. However the draft legislation that accompanied the July 18 paper did not have any wording that would target the legislation at income or assets above a certain threshold. Many of our clients earning much less than $150,000 per year are incorporated, use income sprinkling with their spouse and would like to accumulate investments if there is any cash left over after paying taxes and all of the other expenses that are part of running a business. These businesses will all be negatively impacted by these changes.

One of the justifications given in the paper for the need for these changes is the increase in the number of incorporations from 1.2 million in 2001 to 1.8 million in 2014. There are many reasons for this increase in the number of incorporations.

- In 2004, the Province of Ontario agreed to allow doctors to incorporate specifically so they could benefit from some of these tax rules. This was done in lieu of fee increases and resulted in a wave of incorporations by doctors in Ontario.

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- It is much easier to incorporate now. Often it can be done online by an individual who is starting a business without the need for expensive legal or accounting advice.

- Incorporation provides many non-tax related benefits, such as liability protection for the owner of the business.

- Past court cases resulted in many lawyers and accountants, who practice in partnerships, incorporating two corporations for each lawyer or accountant in the firm. The ability to do use this structure to benefit from additional small business deductions was eliminated in the 2016 Federal Budget for the 2017 tax year and we are just now starting to see the impact of this change.

- Some industries, such as the oil sands and in some cases the Federal Government itself, will not hire individuals on a contract basis. They do not want to take on any risk of the contractor being deemed to be an employee. So individuals are forced to incorporate in order to bid on contracts.

- The financial crisis in 2008/2009 resulted in many people being out of work. If they were not able to find employment, many people decided to start businesses and incorporate for tax and non-tax reasons.

- The economy and the population of Canada have grown in this period. It is to be expected that the number of corporations would also increase in this 14 year period.

If there are individuals incorporating who are not legitimately engaging in a business, we believe the current personal services rules and GAAR rules already provide the Government means to attack and penalize any such abuses.

We strongly recommend that the Government extend the consultation period beyond 75 days so that a true, full, collaborative consultation can take place. If the goal of the Government is to increase taxes only on a specific group of high income earners, there are ways that can be done without causing the excessive collateral damage to small businesses, farmers and others who are not high income earners. It can also be done in ways that will not create exceptionally complex new rules which will be very costly for all businesses to comply with. Our firm (and we believe the entire accounting, legal and small business community at large) would be willing to work with the Government to achieve these goals if we are given the time and opportunity to do so.

Never before in the 100 year history of income taxation in Canada have such extensive tax reforms been undertaken in such a short period of time. Many of the rules being amended or re-written with these proposals have been in place for approximately 45 years. We do not see why there is now an urgent rush to implement what we believe to be deeply flawed changes. We urge you to please take more time and get these changes right.

With regards to the specific proposals in the July 18 paper, there are numerous scenarios with dramatic negative consequences should these proposals be implemented as drafted. We hope that many of these scenarios would fall under the category of "unintended consequences" which will be remedied prior to final legislation being passed. However, comments from Department of Finance officials at the recent Canadian Tax Foundation Policy Conference suggest that some of these outrageous outcomes may actually be intentional. If they are intentional we would suggest that the Canadian public be fully informed regarding the Government's intent.

Below are some specific scenarios, outcomes and areas of concern with the proposals that we believe must be addressed and improved prior to implementation.

Elimination of "pipeline" post-mortem tax planning. If pipeline tax planning is eliminated by the proposed changes to the Income Tax Act, this will result in double or triple taxation on death. Some analyses suggest that this could result in tax rates as high as 93% on death. This result is patently unfair and cannot be allowed. Changes must be made to the draft proposals so that no Canadian is faced with paying 93% taxes on the death of a family member.

Imposing much higher taxes on the sale of a small business to a family member, when compared to the taxes that would apply if the exact same sale took place with a non-family member. In New Brunswick the sale of a business to a non-family member would be taxed at the capital gains rate of 26.7% (assuming the top marginal tax bracket). The tax rate could even be as low as 0% if the Lifetime Capital Gains Exemption applies and the selling price is below the maximum LCGE threshold of $835,714. The exact same sale at the exact same price would be taxed at 46.3% if the sale is made to a family member. This puts small business owners (regardless of income level) in the terrible position of having to decide whether they sell their business to the next generation and face an additional tax burden of between 19.6% and 46.3%, or do they sell to a non-family member in order to realize the full after-tax value of their business. Changes must be made to the draft proposals to avoid this scenario. Legitimate sales of businesses at full fair market value should not face such draconian tax outcomes simply because the purchaser is related to the vendor.

The July 18 paper and subsequent comments from the Minister since July 18 make very clear that the proposals in the area of passive investment income earned inside a corporation are not intended to be retroactive. However the interaction between the passive income changes and the income sprinkling changes can still have the effect of a retroactive tax change. For example, many small business owners have been saving inside their corporation specifically for the purpose of helping to pay for their children's post-secondary education. They have planned to accumulate the savings and pay dividends through a family trust to the child to fund their education. It has been anticipated by the small business owner that this dividend would be subject to little or no tax based on rules that have been in place for decades. With these proposed changes, the funds saved for the kids' educations are effectively (and retroactively) cut in half. The active owner of the business will now have to withdraw the funds as a dividend to themselves to avoid the new income sprinkling rules. As a result, the income will be taxed at 46.3%. This means that their education fund has been effectively cut in half and in many cases they do not have the ability make alternative plans. We suggest that some sort of carve out or grandfathering be introduced to prevent this outcome.

Another similar example to the immediately preceding example would be business owners who have saved for their retirement inside their business – either by accumulating funds in the corporation or by selling the assets of the corporation (rather than selling shares) and retiring. Many business owners have been planning for this scenario for decades and many are already in their retirement years with their entire retirement fund inside a corporation. If their plan had been to use dividends to both spouses in retirement and now that is not going to be possible due to the income sprinkling rules, the Government will effectively be applying a retroactive tax on their retirement fund and there was no way for them to plan for this. This could very easily result in their retirement fund no longer being adequate for their needs but it is too late for them to do anything about it.

It has been suggested by the Minister of Finance and others that these proposals (in particular the passive investment income proposals) will not impact anyone making less than $150,000 per year. The theory that appears to be underlying this claim is that people under this level of income can use their RRSP and TFSA to save and invest rather than investing inside a corporation. However many businesses save and invest inside a corporation not for tax reasons, but as a way to be cautious and prudent. Having funds set aside allows them to weather an economic or industry downturn or an unexpected event such as a flood, fire or health problem. In our firm we have seen many clients use accumulated savings and investments for exactly this purpose. It has allowed them to continue business and weather tough times without having to lay off staff. The various options under consideration regarding passive investment income inside a corporation do not currently provide any means for businesses to accumulate savings of this nature without facing tax rates as high as 53.3% inside the corporation and an additional 46.3% if the funds are withdrawn from the corporation. The ability to save inside an RRSP does not help a business in this scenario. In order to save inside the RRSP, the business owner would need to have enough available RRSP contribution room. And even if they have the required room available, when the business needs the funds they would have to withdraw the funds from the RRSP (which could push them into a higher tax bracket), pay personal tax on the withdrawal, and then put the funds into the business. Assuming the business survives the downturn or unexpected event, when the business is back on its feet they would not be able to begin accumulating savings inside their RRSP again because they will have lost the RRSP contribution room. We believe that some sort of accommodation needs to be made to these proposals to allow businesses to accumulate and invest some funds inside their corporation for these purposes. Otherwise, we expect many businesses will just accumulate funds and hold it as cash rather than invest it and earn a return. This will be the only option for accumulating a rainy day fund in the business without facing excessively high taxes.

It is unclear to us why businesses should not be allowed to accumulate investments inside a corporation. In many cases business owners earn very little income for many years before a business becomes successful. During these years the owners are not able to accumulate investments inside a corporation. When they begin to have success and some excess cash flow, many owners do not have enough RRSP contribution room or time to catch up and save adequate funds for their retirements. We believe that, if any of the proposals being considered for passive investments are to be enacted, RRSP contribution limits should also be increased to allow business owners to adequately save for their retirement. Several articles published during this consultation period have shown how RRSP contribution limits are not adequate for allowing business owners to be on equal footing with employees who have a pension plan when they enter retirement.

It is also unclear to us why income sprinkling is abusive or considered a "loophole" when done by small business owners, yet it is acceptable and encouraged for pension income of retirees. Many small business owners do not have a pension which can be split with a spouse in retirement. Some will have the ability to split their RRSP with a spouse in retirement but many small business owners rely on the proceeds of selling their business to fund their retirement. The proposed income sprinkling rules will prevent small business owners from splitting this major source of retirement funds with a spouse and it puts them at a distinct disadvantage to employees with a pension. We believe some allowance should be made so that business owners are not placed at a disadvantage when it comes to funding their retirements.

We are very concerned with the impact the proposed changes will have on investment in startups. Many startup businesses rely on family member and angel investors to finance their ventures. Family members will not want to take on the risk of investing in a startup if they cannot expect a reasonable after-tax reward. Also, many angel investors invest in startups by using funds they have accumulated inside a corporation. The proposed changes to passive investment income will undoubtedly have a negative impact on investors being willing to take on the high risk of investing in a startup. These startups are a major source of new jobs and innovation in Canada and they need to be supported.

We are also very concerned about the impact these proposed changes will have on jobs, the economy and charity. Even if the changes only impact the high income earners (which we do not believe is the case) the funds required to pay the additional taxes will have to come from somewhere. Many small business owners will have to decide if they have to raise prices, hold off on investing in new equipment, not hire new staff, fire existing staff, not donate to charity, etc. in order to get the funds to pay the higher taxes. This will have a negative impact on the economy. There have also been reports of doctors and investment already leaving the country just as a result of the announcement of these proposals. This will also have a negative impact on the economy.

We thank you for your time in reading and considering our comments on these proposed tax changes. We sincerely hope that this consultation process is used to gather constructive feedback from the business community so that improvements can be made prior to implementation.

Yours very truly,

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cc. Matt DeCourcey, MP
Karen Ludwig, MP
Wayne Long, MP
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