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Department of Finance Canada
14th Floor
90 Elgin Street
Ottawa, ON K1A 0G5

September 15, 2017

Dear Sir or Madam: **Re: Tax Planning Using Private Corporations**

We are writing in response to the Department of Finance release on July 18, 2017 of various documents for consultation on the proposals to changes in the taxation of private corporations. We are an independent firm of Chartered Professional Accountants located the Niagara Region, Hamilton and the Halton Region of Ontario. Our clients primarily consist of family-owned and operated small business corporations. Our review of these proposals has led to a conclusion that a significant amount of our clients will be affected by these proposed changes.

Along with our numerous small business clients, our Firm is concerned that there are several technical deficiencies in the draft legislation as proposed. Further, it appears that there could be many unintended consequences of the legislation compared to what the Government's message has been and who it is intended to impact.

Tax System Fundamentals

A widely held belief on what a tax system should entail was outlined by economist Adam Smith in The Wealth of Nations:

"Good taxes meet four major criteria. They are (1) proportionate to incomes or abilities to pay (2) certain rather than arbitrary (3) payable at times and in ways convenient to the taxpayers and (4) cheap to administer and collect."

Our current tax system encompasses these principals. The graduated tax rate system in place for individuals captures the ability to pay and ties the taxes to income levels. While there is already some uncertainty in our complex tax system, we are concerned that the proposals, as currently drafted, will add substantially more. In addition, we feel that business owners will have to spend more time on tax compliance instead of focusing on growing their businesses and creating jobs. It will almost certainly create additional cost for Canada Revenue Agency to administer the changes and review taxpayers for compliance.

In addition to Adam Smith's comments, the current Canadian tax system is based on integration - a taxpayer should be indifferent as to whether they earn a dollar inside of a corporation and dividend out the amounts to the shareholder versus earning the dollar individually. The current tax rates in the Canadian tax system are almost perfectly integrated. The proposed changes will result in tax in excess of 70% in some cases; which is far higher than the top marginal personal tax rate in any province.

Small Business Statistics in Canada

According to the Government of Canada website https://www.ic.gc.ca/eic/site/061.nsf/eng/h_03018.html, the following are the small business statistics as of June, 2016.

- As of December 2015, there were 1.17 million employer businesses in Canada, as shown in Table 1.1-1. Of these, 1.14 million (97.9 percent) businesses were small businesses, 21,415 (1.8 percent) were medium-sized businesses and 2,933 (0.3 percent) were large enterprises.

- While it is well understood that small businesses make up nearly the entirety of all businesses, just how small these firms are is not common knowledge. Of the 1,167,978 employer businesses active in Canada, micro-enterprises (firms with 1 to 4 employees) constitute 54.1 percent of all private employers, which is the largest SME group. If the groups of employer businesses with 5 to 9 and 10 to 19 employees are included, they account for 86.2 percent of employer businesses.

- In 2015, the Canadian private sector employed over 11.6 million people. The majority of these employees worked for small businesses, constituting 70.5 percent (8.2 million) of private sector employment.

- Small businesses account for 97.9 percent of all firms in Canada and proportionally play a large role in net job creation. The contribution to net employment change between 2005 and 2015 (1.2 million jobs) was 87.7 percent attributable to small businesses. Medium-sized and large businesses, which account for 1.8 percent and 0.3 percent of all firms respectively, created just 7.7 percent and 4.6 percent of net new jobs over the same period.

Data collected from Statistics Canada and other official government sources shows that two thirds of small businesses earn less than $73,000.

In addition, it is these small business owners who:

- are willing to risk all of their assets;
- risk their family harmony due to working regular 70-90 hour work weeks;
- have no EI benefits in the event of a business fail;
- have to pay for their own pension/retirement savings; and
- have to pay for their own life, disability, critical illness and medical insurance.

There is no comparison to an employee even though that was what was outlined in the proposals. The employee has government benefits available in the event they lose their job, they work 35-40 hours a week and most are provided with benefits to some degree. The tax system should reward those who are willing to take on risk, and at the end have a larger reward available to them.

As you can see from the statistics, it is small businesses that are the backbone of the Canadian economy and job creation, not the ‘wealthy large and medium-sized businesses’ as implied. Any increase in tax rates for these small business as proposed, will limit the capital that business owners have to reinvest into their company and will therefore, limit the creation of middle class jobs as their business grows. From speaking with many small business owners over the course of the summer, these proposals may lead them to working less hours, hiring less people, and in some cases, closing up shop and taking employment elsewhere. A tax system should be fair and neutral and not impact anyone’s business decisions. Based on our feedback and conversations with business owners, this will not be the case if the proposals are passed as indicated. It is not unfair to say that these tax measures will contribute to stunting the growth of the economy based on the statistics above and bring Canada into a recession.

Executive Summary

The purpose of this submission is to outline various concerns that our Firm and clients have with regard to the proposals released by the Department of Finance on July 18, 2017. Our primary concerns are as follows:

1. The proposed measures will negatively impact the majority of small business owners, not just the “top 1%” as suggested;
2. The proposed measures appear to have retroactive implications which contradicts tax fairness and certainty in the system;
3. The proposed measures may result in double or triple taxation for taxpayers which does not result in tax fairness;
4. The proposed measures will increase the administrative and compliance burden on taxpayers which will further complicate the tax system and lead to further non-compliance; and
5. These proposals coupled with increased tax rates could drive more business to the underground economy.

Income Splitting Measures

Canada’s personal income tax system is based on fundamental principles which include:

- An individual’s income tax liability is determined based on his or her income for a year, and generally without regard to the taxable income of family members or other related persons; and
- An individual’s income tax rate increases as the amount of taxable income increases, known as a Graduated Rate Income Tax System.

Due to the above fundamental principles, a family unit can reduce its combined personal income tax by having income that would have been taxed as income of a higher-income individual, realized by family members who are subject to taxation at a lower tax rate or who may not be subject to tax at all when it would have otherwise been taxed as income of a higher-income individual. This concept of reducing a family’s tax burden is commonly referred to as “income splitting”. To discourage families from undertaking transactions or creating structures that allow for income splitting, the Income Tax Act already includes certain measures including reasonability tests for wages, attribution rules, and the “Kiddie Tax”, also known as the tax on split income (“TOSI”) rules, which currently only apply to minors below the age of 18. The proposed rule changes as we understand would:

- Apply to other family members, including adult children, spouses and common-law partners;
- Expand the types of income that are caught under the rules;
- Apply to “sprinkled income” amounts where the amounts are “unreasonable” under the circumstances; and
- Expand the situations in which the TOSI rules apply.

A major issue with the proposals is what will be ‘reasonable under the circumstances’. It is our understanding that the term ‘reasonable’ will not be defined in the Income Tax Act. This uncertainty does not create a fair tax system, and makes it very subjective and costly to administer. In addition, having the more restrictive rules apply to taxpayers who are up to 25 years old is contrary to all other aspects of law. It has been determined that by the age 18, individuals are given the right to vote, the ability to go to war to protect our country, and to legally sign contacts to name a few very important items.

Another issue is the term ‘regular, continuous and substantial basis. What exactly does this mean? It will add further confusion and unnecessary complexity to an already complex tax system.

If the main intent of the government is to stop the use of lower family member tax rates, a much simpler solution than the proposed TOSI rules could be to have consolidated family tax returns, much like the United States of America’s system. By having a family unit (spouses and minor children) filing one tax return on combined income would actually simplify the system and cost of compliance by reducing the number of income tax returns that the Canada Revenue Agency needs to process annually. In addition, it would also eliminate the need to have to 'income split' amongst family members.

Conversion of Income into Capital Gains

Through certain transactions and corporate reorganizations, shareholders of private corporations were able to convert what otherwise would have been a taxable dividend (with a top marginal tax rate of 45.3% in Ontario for non-eligible dividends) to a capital gain (with a top marginal tax rate of 26.75% in Ontario); creating potentially tax savings up to 18.55%. It is our understanding that the Department of Finance was aware of this planning and wanted to shut it down. The proposals look to combat this with changes to Section 84.1 and new Section 246.1. In our opinion, these new provisions go far beyond the targeted abuse.

- The proposed change to Subparagraph 84.1(2)(a.1)(ii) is punitive as it results in double taxation that cannot be avoided. The original intent of Section 84.1 was to ensure that "surplus stripping" was only allowed where taxes have been paid – not to apply double taxation.
- The proposed change to Subparagraph 84.1(2)(a.1)(ii) is retroactive as it impacts taxpayers regarding transactions that occurred before July 18, 2017. There is no recognition given for taxes paid by related parties in the past.
- Section 246.1 appears to have no bounds and could apply to ordinary business transaction, such as, the sale of assets to a third party or family member as part of legitimate succession planning.

Given the integration concept of our tax system mentioned above, it would be a far simpler solution to change the capital gains inclusion rate to integrate our tax system better with this type of income. This solution is not as complex and would accomplish what the government's agenda is with respect to this type of remuneration planning by business owners.

If the current rules are to be kept similar to those as drafted, they should not be made retroactive to allow proper adjustments for business owners' remuneration strategies – based on the fairness and certainty principles within our tax system.

Finally, this type of change to the provisions in 84.1 of the Act will potentially create up to 70% tax for a shareholder because of double tax. A common strategy used in post-mortem tax planning is the 'pipeline strategy'. This strategy avoids the estate from having to pay tax on a capital gains tax on shares and then for the beneficiaries to then have to pay another layer of tax when the capital of the company is eventually stripped out of the company; while getting no credit for the increased cost base of the shares created on the death of the shareholder against the taxable dividends. There currently is a relieving provision in the Act in subsection 164(6). A practical issue with this section is it only applies to the first filing year of an estate. In reality, many estates last long after one year due to disputes or the nature and size of the estate. If the rules are enacted as drafted, some consideration should be given to extend the use of 164(6) to three years to match the graduated rate estate tax rules. Another consideration would also be to consider a mechanism where the cost base of the shares created at death can be used to offset further dividends paid out to avoid double taxation. Perhaps the legislation could allow the dividend reporting to be on the terminal return instead of the estate return on an elective basis.

Holding Companies

Canadian Controlled Private Corporations ("CCPC") pay an initial low rate of tax on their "active business income". In Ontario, the current rate is 15%. When the after-tax profits of a CCPC are paid out as dividends to the shareholders, the shareholders pay another level of tax on the dividend such that the total taxes paid by the CCPC and the shareholder, equal the tax an unincorporated business owner would pay on the same amount of business income. It is not uncommon for business owners to want to move the profit earned by an operating CCPC to a holding company for creditor protection reasons. As mentioned above, since the business owner is taking on substantial risk, they want to be able to protect prior years' profits as this will be the capital they use to reinvest into their business. It also will be their retirement fund as they do not have the luxury of having an employer-funded pension plan.

The rules as proposed are extremely complex and will require large professional fees to be incurred for any business with a holding company so they can comply with our tax system. This is contrary to the simplicity concept of a good tax system.

In recent years, the changes to subsection 55(2) have already made it increasingly difficult in terms of compliance and taxation for small business owners to protect their capital. Adding the new proposals may encourage non-compliance or unreasonable investment decisions to try to preserve the little capital they have.

In addition to this, we do not understand why these provisions are even necessary. Passive investment income is already taxed at the highest rate in CCPC's and there is no deferral advantage to earning investment income in a corporation. These proposals should be abandoned in its entirety and will only go towards harming business owners and their chance to grow their business and live a healthy retirement as employees with pensions and benefits would be able to.

With the tax changes over the past few years, along with an increase in CPP contributions planned, a large increase in the minimum wage in Ontario coming, Canadian business owners have faced a massive increase in the costs to do business. The changes to the eligible capital property rules and subsection 55(2) of the Income Tax Act have caused more tax compliance time and more uncertainty into the Tax system.

Given the significant changes and uncertainty surrounding the changes already made, adding the July 18, 2017 proposals seems to make tax planning and general tax compliance extremely difficult for Canadians to comply with in a reasonable, accurate manner.

We would welcome the opportunity to discuss the proposals, our concerns, and our suggestions with any officials from the Department of Finance. If you have any questions on this submission, please do not hesitate to contact us.

DURWARD JONES BARKWELL & COMPANY LLP

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cc: Rt. Honourable William Morneau
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