August 16, 2017

Rt. Honourable Bill Morneau,
Honourable Andrew Scheer,
Department of Finance

Re: Tax Planning Using Private Corporations

On July 18th the Department of Finance issued the above referenced document as a proposed measure for consultation. I have been in practice working with small owner managed businesses for over 30 years. Small business is the life blood of the Canadian economy. Statistically small businesses that employ less than 300 people provide more than 50% of the jobs in this country.

I have read a lot of articles on this proposal. I am struck by the misconceptions both of the Finance department and by a number of writers. This proposal is not aimed at the wealthiest Canadians at all. If you have a holding company with $20 million or more in investments then these proposals do not affect you at all. Those companies can elect to be passive investment holding companies and there is no change to their circumstances. If you are a small business trying to earn active business income of $200,000 or less with several employees then this proposal affects you profoundly. These proposals will affect whether businesses carry on, they will affect decisions that small business owners make, and they will affect how small businesses will behave.

It is also important to understand tone. The tone of these proposals is completely misguided. Private corporations definitely pay their fair share of taxes. The implications that they do not, as implied by this document, is just not accurate. It also sends the wrong message to the world about Canada and misleads the general public about the true nature of the circumstances.

That is why it is important to note the fallacies that have been accepted in this document and examine the consequences that these proposals will have:

FALLACIES

The first fallacy is that this is an attack on the rich. If this were an accurate document, Finance would document that the very richest Canadians, just like Bill Morneau and Justin Trudeau, who have holding companies that no longer have active business income, will not be affected. As I stated before, these holding companies can simply declare that they are now just holding passive investments and nothing in their world changes. It should be noted that holding companies pay taxes on investment income at 50%, this is not the tremendous tax dodge that many uninformed Canadians believe to be so.

The second fallacy is the indication that corporations are being formed solely for tax reasons. That is absolutely not the case. In fact all three levels of governments are reducing the number of employees that they have and turning to outside consultants. This is also true for large public companies. These entities force consultants to be incorporated. In the litigious environment that exists around the world corporations provide legitimate credit protection for entrepreneurs. A corporation is also a better vehicle from a marketing and banking and service provider standard. A corporation actually costs significantly more than a proprietorship to form and to operate. So a decision to incorporate is not made lightly.

The third fallacy is that sprinkling income (dividend and salary) is a serious issue. The truth of the matter in most small businesses a spouse is already very involved in the business, be it on a record keeping basis or on a consulting basis as well as with dealing with customers. Any employment income earned by the spouse has always been tested for reasonability for over 30 years. Sprinkling income to children under 18 is already dealt with and has been for over 20 years. Once a child reaches full time employment the advantages of "sprinkling" have very limited tax savings. The vast majority of this proposal is pure posturing.

The fourth fallacy is the comparison of a small business owner to that of an employee to document unfairness. Employees have health care, severance pay, pensions and employment insurance. None of those factors have been considered in the evaluation performed by the Finance Department. In the example used by Finance, Jonah and Susan both earn $220,000. Finance documents that Jonah dividends amounts to his children. The tax rules on this are very specific if the money does not stay with the children then it will be attributed back to Jonah and he will have to pay tax on that amount. The tax savings mentioned by the Finance department total a $35,000 advantage for Jonah. If we compare apples to apples the following additional considerations should be made: The severance that Susan accumulated each year amounts to about $13,000, the health care costs which Jonah must bear will be about $8,000 per year for the family to be equivalent to Susan. The tax preparation and record keeping requirements as well as the quarterly HST filings will result in average additional administrative costs of $6,000. If we add the employer portion of CPP and a 5% employer contribution to a pension plan for Susan, there is no savings at all for an independent consultant.

The fifth fallacy is that holding passive income in a corporation is a bad thing and that a massive sum of money is being shielded. The truth of the matter is that most small businesses do not earn over $250,000 annually. This proposal wants to tax income left in a corporation at 73% (according to a number of tax professionals) no matter what the size of the business be it a profit of $100,000 or $10,000,000 the penalty tax is the same. There is nothing about fairness in this proposal. This proposal has no consideration of the importance of diversification. Large corporations can diversify to different markets and into different product lines. That is simply not feasible for a company that has 15 employees. Their diversity is in accumulating investments to backstop the business from economic difficulty or sudden calamitous events. In 2008 in Ontario and British Columbia, or 2015 in Alberta, small businesses that diversified made a great decision that saved jobs. Entrepreneurs make smart decisions to diversify when times are good to ensure that they will survive when things go poorly. In the both of the examples of 2008 and 2015 small businesses could not count on government or banks to help them in tough times. Small business in bad times need funds to tide them over. They are not like public corporations that get government bailouts. In our Practice alone this saved hundreds of jobs for our entrepreneurial clients in 2009 so that they could be ready to pick up the pieces when the economy recovered. If an entrepreneur ever takes the money out for personal purposes then the taxes paid will be fully integrated as if they were employees. As stated before, investment income within a corporation is taxed at 50% so this new income will not have a beneficial rate. The ability to accumulate income in a business also aids in the transition of the business. Many small corporations have no ability to be sold given the nature of the business or the business could just be the entrepreneur. This proposal inhibits the ability of these people to retire and is all about Finance and the Liberal desire to front end collection with no regard for future consequences.

The final fallacy is that the conversion of a private corporation's income into capital gains is an extensively used method to avoid taxes. Finance proposes to more than double the tax to 59%. The example given talks about selling an asset to another related company controlled by the same person. The fallacy is that it is a common issue, the problem is the solution to this specific instance. In this circumstance Finance is basically taking a sledge hammer when only a scalpel is needed. This proposal will have far reaching consequences vastly greater than the small issue they are intending to address. This will limit the ability of small businesses to continue, be it through the transfer of the business to children, or to employees. The example problem cited by the Finance department is a very specific technique that has very limited applicability in general circumstances. In contrast, the proposed solution has widespread issues and will have a very detrimental effect on business transition.

CONSEQUENCES

The first consequence is that of competitiveness. The proposal spends three pages documenting Canada's relative competitiveness. These proposals take an already shaky comparison and make Canada very uncompetitive. In the UK and the US investment income earned by a small business is taxed at 19%. In fact, in the US, that rate is the total tax in the hands of the entrepreneur. In Canada, Finance only looks at the income in the company. When you factor in a proposed 73% tax on investment income Canada is the WORST among the seven countries in the chart. Finance has noted that the fastest growth in the economy is in the service industry. That includes the "Tech" industry. This industry is the most mobile industry in the world. When Canada is not competitive, businesses look for better operating environments. These proposals when factored in combination with the highest tax personal tax rates in the G7 will cost jobs. It should be noted the US announced changes to their immigration policies to target skilled people for immigration. Other countries are doing the same thing. Canada is pushing small business jobs away.

The second consequence is that "sprinkling" will not stop, it will just change. In the example cited, Jonah will employ his wife to help him deal with the incredibly complex new rules that finance has just introduced. The 19 and 21 year old children will be given summer jobs. For the wealthy people, like Bill Morneau and Justin Trudeau, it took me about 15 minutes to figure out a way around the "sprinkling" problem that Finance is so concerned about. I am sure that those individuals, with their advisors, can continue to "sprinkle" without any second thoughts.

The third consequence is aggressive tax planning. These proposals make it worth it for the small business owner to engage professionals to defeat taxes where the government gets more income with no risk than the taxpayer. If enacted, there will be many decisions made to take steps to counter the effect of these proposals as much as possible.

The fourth consequence, which goes hand in hand with the third consequence, is a growth in the underground economy. High tax countries have always had tremendous problems with unreported amounts. These proposals are creating just such a situation in Canada. Finance does not report in their tables that Canada has a significantly larger underground economy than the UK or the US. This is not a function of honesty this is function of implied fairness. Even right now, high tax employees are very eager to get forms of compensation that are not taxable. This will be multiplied significantly for small business owners. This is not an environment which this country should be proud of.

The fifth consequence will be a direct result of passive income in a corporation. If you cannot relocate out of Canada, then you will take different steps to avoid a 73% tax. If entrepreneurs do not diversify then downturns will hit the Canadian economy more severely. If they do diversify then the entrepreneur will likely keep the money as cash rather than invest it to pay a 73% tax. This will result in a decrease in revenue for Canadian Governments which would have got 50% on any investment income the company earned. This will also result in less income for our financial services industry and advisors who also pay taxes. In the alternative, entrepreneurs will try to invest excess income in investment products that provide a return of capital as a distribution or have long term results. The goal will be to wait out a government that is obviously so greedy and short sighted. For large private corporations this tax is even easier to avoid, I am confident that their professional advisors have the same ideas that I have to avoid this tax.

The sixth consequence is charitable organizations. In this time of increased reliance on charitable organizations to provide social services, this document makes it unattractive for wealthy people to donate shares to charity from their holding companies. This has been a huge part of charitable revenue over the last 20 years. This will impair the ability of charities to raise funds for necessary social services to aid communities all across Canada. In our Practice alone several planned foundations have been put on hold or there is a plan to wind them up in the last month.

The seventh consequence is health care. In this country, there is a struggle to attract good doctors. In all provinces, payments to health care specialists is capped. To equalize and to incent medical doctors, they were allowed to incorporate. These proposals increase taxes on the very professionals needed in Canada. These professionals are very mobile. The specialists will leave. This will make wait times that much longer and service that much poorer. Remote parts of Canada will have that much more difficulty attracting doctors to their community.

The final consequence is the continuity of small businesses. These proposals make it very hard for businesses to do any succession planning. A small business owner under these proposals is rewarded for selling to a large corporation. The punitive elements of these proposals mean that small businesses will not be continued on. These proposals basically state that Finance does not want businesses to continue to a new generation. This is extremely detrimental to jobs and to the economy. Large businesses and foreign entities will be glad to scoop up these small businesses which is yet another export of jobs or an elimination of jobs upon amalgamation.

CONCLUSION

I have never in my 30 year career, written a letter to protest proposals introduced by any government. Our firm has worked with small businesses and non-profit enterprises for over 60 years. We are so saddened that a government in this great country believes that these proposals will better this country. Small business owners are some of the hardest working individuals because their business is so personal for them. These proposals are so egregious and misdirected that they will significantly impair Canada economically.

In this document, the Liberal government, takes great pride in the competitiveness of Canada from a corporate standpoint. It is important to note that all of these competitive policies, they take pride in, were introduced by the Conservative government. The Liberal government has only introduced measures to make corporate Canada less competitive.

All small business owners should recognize that these proposals are an attack on them personally. The Finance department and the Federal Liberals are incorrectly casting small business owners as wealthy tax cheats. These proposals will cost jobs for people in small business, financial services and health care. They will also reduce the incentive for corporate charity. It is clear that these proposals send a message that this government is all about taxation and greed.

The passage of these proposals will have far reaching implications and will definitely demonstrate that this government is bad for the economy and for jobs.

Yours truly
On behalf of all of the partners,

Gordon Lee

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