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The Honourable Bill Morneau, Minister of Finance
Department of Finance Canada
90 Eglin Street Ottawa,
Ontario K1A 0G5
Fin.consultation.fin@canada.ca

Dear Minister Morneau,

Re: Tax Planning Using Private Corporations

The Calgary Chamber exists to help make businesses more successful, and in doing so make Calgary the best place in the country to live, work, and grow a business. It's a job we've been proud to do for over 125 years.

Today, the Chamber represents close to 2,000 businesses and over 400,000 employees, and our focus remains unwavering: to help grow businesses, and improve the competitiveness of the business environment.

The Chamber believes the tax system should be fair, minimally complex, and encourage growth for all Canadians. Instead, we believe the proposed changes will create additional uncertainty and administrative requirements for businesses, and unfairly increase the tax burden.

Given that the proposals represent some of the most significant tax policy changes to affect private corporations and their shareholders since 1972, we urge the Government of Canada to extend the consultation period to allow for greater discussion and consideration of the potential impacts.

The submission will address the following five issues with the proposed tax changes:

1. Canada's business competitiveness;
2. Income sprinkling;
3. Holding passive investments inside a corporation;
4. Converting income into capital gains; and
5. Consultation process – rhetoric and length

While the Chamber does not support the proposed tax changes, our submission provides recommendations that we hope will help achieve the government's objective of creating a fair tax system, while mitigating the burden placed on small businesses. The content and recommendations are based on direct member consultations, 150 online surveys responses, and roundtable discussions with Calgary businesses and elected officials.

1. **Canada's business competitiveness**

Canada is currently in a global competition to attract talent, business, and investments. The Chamber is concerned that these tax changes will not only increase compliance and overall tax burdens for many businesses, but will significantly reduce Canada's overall competitiveness. As will be outlined below, we urge the federal government to not only consider the costs of these proposed changes, but to consider these added costs as being implemented at a time where policies from other levels of government are making it harder for businesses to succeed.

The proposed changes are adding another layer of complexity on top of an already complex and administrative-intensive tax system. Many businesses have reported issues and administrative costs associated with tax compliance. In a 2014 survey by Ivy Business School and KPMG, medium-sized businesses cited the review and audit process as creating considerable complexity and costs for their companies. Specifically, these costs arose from complying with onerous laws, and difficulties with appealing decisions – the proposed changes will exacerbate these issues. In fact, in *Canada's Top 10 Barriers to Competitiveness in 2016*, the Canadian Chamber describes the cost and complexity of complying with Canada's tax laws as a large barrier that discourages business growth.

We believe adding a subjective reasonableness test as described in the proposal, along with the increased exposure of businesses to these new rules, will increase the difficulty that many business owners have complying with Canada's tax system. The Chamber is especially concerned that the added complexity will impact smaller businesses who do not have the luxury of being able to allocate additional resources to navigating the tax system.

In addition to increasing complexity, the proposed tax changes will increase the overall tax burden paid by many small businesses. For example, under the proposed rules, passive income could now be taxed at a rate of over 70 percent. The dividend to capital gain conversion proposals will also cause the sales of businesses to family members to almost double their taxation burden. Furthermore, the proposals regarding income sprinkling will dramatically increase the overall family tax burden for middle class business owners. By discouraging financing from family members, the income sprinkling proposals will make it harder for new business start-ups who tend to rely on family members for early-stage capital.

Unfortunately, these changes are being implemented on top of a number of other policies that are eroding Canada's cost competitiveness.

In Calgary, businesses are facing a new carbon levy, rising cost of labour due to minimum wage hikes and new labour code reforms, escalating municipal property taxes, higher corporate and personal income tax rates, greater Canada Pension Plan contributions, and trade uncertainty – all while consumer spending remains low. These added costs, in combination with the economic downturn, has resulted in many Calgary businesses closing their doors. In fact, a record number of Calgary businesses – 7,124 – ceased operations in 2016.

During consultation with Calgary businesses, we heard that:

- In 2017, a typical medium-sized Calgary business (less than 500 employees) will likely pay an extra $75,000 – compared to 2016 – due to minimum wage hikes, City property tax increases, and the carbon levy. In 2018, this figure will increase to $162,000.

Many businesses across Canada are facing the same challenges as their Calgary counterparts. While economic forecasts have illustrated rapid 2017 first half growth, many Canadian businesses have yet to reap the benefits of recovery and still face significant challenges.

In terms of overall business competitiveness, Canada still has room for improvements. For example, Canada ranks 22nd on the World Bank's most recent index on the ease of doing business. We have gone from having the 19th highest tax burden on investments by medium-sized and large corporations in 2012, to the 14th-highest among 34 OECD countries in 2014. Furthermore, there are still signs of a sluggish Canadian economy moving forward. For example, in Budget 2017 the government forecasted average annual economic growth of 1.8 percent over five years.

As other jurisdictions continue to look for ways to improve their business environment, it is extremely important that Canadian policies, and tax system, do not reduce our ability to compete. Overall tax reform – not just for private corporations – may be needed in Canada. However, it must go hand-in-hand with a pro-growth agenda.

While Calgary businesses do not support the proposed changes, the Calgary Chamber recommends the government:

- **Consider a comprehensive review of the Canadian tax system with simplification as a main objective.** With the United States looking to reduce the burden of corporate taxes, the Government of Canada must ensure Canada has a competitive tax structure. To that end, Canadian tax reform should aim to reduce complexity, along with the overall burden of corporate taxes. The better way to raise revenue and encourage economic growth is instead through lowering rates and seeking to broaden the tax base. Not only will a simple and broad system reduce compliance costs for businesses, but it would reduce the incentive to seek out and implore tax planning strategies. This recommendation is also in line with the recommendations made by the Standing Committee on Finance in their December 2016 report.

2. **Income sprinkling**

Currently, business owners can distribute income to spouses, adult children, and other relatives who are subject to lower personal income tax rates. The government has proposed to broaden the existing rules so family members who are deemed to have received an "unreasonable" amount of income relative to their labour and capital contributions will be taxed at the highest personal income tax rate.

The proposed changes demonstrate a lack of understanding of how many businesses – especially small and growing businesses function. Families, especially spouses or partners, make large investments and sacrifices for a business to succeed. Often, a spouse may give up full time work to support the business – directly and indirectly. Limiting the amount of income that a family member can receive to their number of hours, or to the value of capital that they have contributed neglects the true costs of being a part of a family business. In many circumstances, income is "sprinkled" to family members as a payout for the use of family property as collateral, along with the subsequent income that is given up (i.e., opportunity cost), and the massive risked shared by the entire household.

As the family bears the full risk of business failure, the family should also bear the full reward of business success. In fact, Canadian marriage law operates under this recognition of collective family effort and rights to family-owned property. When a married couple divorce, there is recognition that the success of one is due in part to the contributions of the other. The proposed tax changes are directly opposed to this recognition.

Furthermore, the business community is concerned that the proposed changes to address income sprinkling will harm certain demographics disproportionately. Specifically, concerns have been raised that proposed rules will have a greater impact on women and seniors, who are predominately the non-active shareholders and will be subject to the top marginal tax rate, and lose basic personal tax credits. With two thirds of Canadian incorporated businesses being majority owned by men, expanding the tax on split income (TOSI) to apply to spouses will have a larger impact on women.

Many businesses have also raised concerns over the uncertainty and administrative costs that the proposed changes may lead to as a result of the arbitrary nature of the reasonableness test in the proposed amendments to section 120.4. Obvious questions have been raised. What is reasonable? How will the Canada Revenue Agency (CRA) enforce and administer the new reasonableness test? The subjectivity and requirements of the reasonableness test as laid out by the federal government will result in large uncertainty and admirative costs for business owners, and will likely increase the number of disputes with the CRA.

Finance Canada expects to raise $250 million by the introduction of the new income sprinkling proposals. However, it is likely that the related administration and resulting annual disputes will cost the government, and taxpayer, much more.

During consultation with Calgary businesses, we heard that:

- 63% of businesses will be impacted by this proposed change.

While Calgary businesses do not support the proposed changes, the Calgary Chamber recommends the government:

- **Refrain from applying the TOSI rules to dividends paid to spouses, and common-law partners to fund RRSP contributions.** Spouses play a large role in the many small and medium-sized businesses and should be acknowledged. They share the success, risks, and failures of the business, and the provinces matrimonial property regimes are consistent with this principle. We also urge the federal government to ensure an expansion of the existing rules does not discourage related individuals from making investments that businesses, specifically start-ups, rely on.

3. Holding passive investments inside a corporation

Corporate income taxes are generally lower than personal income tax rates. Thus, business owners have an incentive to earn income in a corporation and retain the after-tax earnings in the business to earn passive income. However, when the passive income is taken out of the corporation it is then taxed at the corresponding personal income tax rate. And when combined with the existing refundable tax, the system is integrated so as to try and make it neutral how such investment income is earned.

This legal practice has been in place since 1972 and has encouraged business and economic growth. The policy reflects the disproportionate burden businesses face when complying with regulations, accessing financing, and accepting levels of risk that employees do not normally accept. Since most business owners do not have pension plans or other social nets, the lower corporate rates are also useful for the entrepreneur to accumulate retirement savings, and mitigate losses – including employment losses – during downtimes.

The proposed changes will deter this savings method. The rationale behind the changes is based on the notion that income earned by employees should be considered and taxed the same as income earned by business owners. This notion, however, neglects the fact that there are many current advantages afforded to employees that businesses owners do not receive. Unlike an employee, a business owner does not receive additional pension contributions, Employment Insurance protections, health benefits, paid sick days, vacation pay, or guaranteed pay cheques.

By discouraging the accumulation of passive investments in Canadian controlled private corporations, the proposed changes will have serious implications on the retirement planning of small business owners. Many small business owners do not have pensions; the investments made within their small business corporation are their retirement funds. According to economist, Dr. Jack Mintz, “Under the new rules, passive income could now be taxed at an almost-confiscatory tax rate of over 70 per cent.”

The ability to retain passive investments within the business is also used to offset some of the risk faced by a business owner, and is often used as a tool to “save for a rainy day.” As we have heard from multiple Calgary businesses, the ability to retain passive investments within their business was a large reason why they were able to avoid lay offs during the recent economic downturn.

It is very difficult for small businesses to access capital in today’s environment. The proposed rules will further expose small business owners and impact their ability to set aside sufficient capital to meet debt covenants, invest in longer term projects, save for retirement, and mitigate the impact of economic downturns or unforeseen emergencies.

Again, the business community is concerned that proposals will disproportionately impact female entrepreneurs. With limited Employment Insurance benefits during maternity leave, female-led businesses currently rely on passive income investments to ensure their business remains operational during maternity leave. These investments protect the female entrepreneur’s income, and her employees’ jobs.

During consultation with Calgary businesses, we heard that:

- 76% of businesses will be impacted by this proposed change.

While Calgary businesses do not support the proposed changes, the Calgary Chamber recommends the government:

- **Allow private corporations to retain a certain level of passive investments tied to a percentage of existing capital or similar standard that considers specific capital needs, and the cyclical realities of a given industry.** At the very least, private corporations should be able to follow a similar model that governs registered charities, which are generally permitted to make passive investments of surplus funds to increase assets to carry out their future activities.

4. **Converting income into capital gains**

Under current rules, income that is normally taxed as dividends could, under certain circumstances, be converted into capital gains which face a lower tax rate. It should be noted that favourable tax treatment has always applied to capital gains, specifically to encourage greater economic growth. In fact, prior to 1972, capital gains were tax free.

The tax changes on capital gains will have a significant impact on intergenerational transfers of businesses, regardless of income level. Many business owners are concerned that the proposals may even make it harder to keep a business within the family than to sell to an unrelated domestic or international buyer.

For example, the tax bill for an intergenerational transfer that results from the death of the owner will effectively increase by as much as 70 percent from what it was before July 18, 2017. Depending on province or territory, the former capital gains rate on death of about 24-27 percent will increase to an effective dividend rate between 40-46 percent. And, this increased tax cost can apply as a result of a death that occurred before July 18, 2017, which contradicts the statement that none of the proposals are retroactive.

During consultation with Calgary businesses, we heard that:

- 66% of businesses will be impacted by this proposed change.

While Calgary businesses do not support the proposed changes, the Calgary Chamber recommends the government:

- **Immediately begin working with the business and professional community to re-develop a framework that ensures the legitimate transfer of a business within a family is not penalized.**

5. **Consultation process – rhetoric and length**

There is an increasing perception among the business community that Canada is becoming less "open for business." The Chamber's recent Calgary Business Leader Market Perception survey has indicated that after reducing fees and taxes, the next best ways a government can support business is by having a more business friendly attitude. This simple, and free change would show that government understands the importance of the business community, appreciates the work they do to create jobs, and recognizes the challenges they are currently facing. Unfortunately, the rhetoric used throughout the consultation period – including the government's discussion paper – has added to the perception that Canadian governments do not understand business realities, nor appreciate the benefits businesses help create. In fact, many small businesses have been made to feel as if they are tax cheats by simply following the law.

The overall rhetoric that these changes will only impact the wealthy, is simply untrue. While the government has suggested that these new changes are targeted to close “loopholes” aimed at the wealthy one-percenters, the truth is that the proposals will affect the majority of business owners who are in the middle class. Data collected from Statistics Canada and other official government sources shows that two thirds of small business owners earn less than $73,000 per year and half of those earn less than $33,000. In fact, we have heard from tax experts that many higher income earners do not use these relatively simple tax planning strategies.

The proposed changes, in addition to other recent policies, are discouraging Canadians from taking the entrepreneurial plunge. A sentiment that we have heard on separate occasions is that current business owners are unsure whether they would recommend the younger generation to start a business in Canada. This is troublesome. Without new entrepreneurs, many jobs will not be created and essential public services will not be paid for.

The business community appreciates the need for tax reform based on improving fairness, reducing complexity, and encouraging growth for all Canadians. However, given that these broad-reaching proposals may be the largest tax reform in decades, a 75-day consultation period, in the dead of summer without debate in the House of Commons, is far too hasty. Greater discussion is needed between government and business to guard against unintended consequences to our economy.

During consultation with Calgary businesses, we heard that:

- 92% of businesses believe the government should extend the consultation period.

While Calgary businesses do not support the proposed changes, the Calgary Chamber recommends the government:

- **Extend the consultation period to allow for proper discussion, and full consideration of the effects of the proposed tax changes**. Extending the consultation period will allow the government to properly consult the business community, and illustrate the government’s commitment to helping Canadian businesses grow and create jobs.

Throughout the submission we have attempted to provide the federal government with practical recommendations that will help achieve the stated tax objectives, while mitigating the burden being placed on small businesses. If you would like to discuss our proposals in further details, please do not hesitate to contact zaddington@calgarychamber.com or at 403-750-0400.

Sincerely,
Calgary Chamber

Zoe Addington

Zoe Addington
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