WINNIPEG CHAMBER OF COMMERCE

Submission to Finance Canada: Tax Planning Using Private Corporations
As approved by the Board of Directors: September 28, 2017

ABOUT THE WINNIPEG CHAMBER

Founded in 1873, The Chamber is Winnipeg's largest business organization, dedicated to fostering an environment in which business, and all Manitobans, can prosper. The Chamber's vision is for Winnipeg to be a competitive, technologically innovative city with a skilled labour force and modern infrastructure to support existing and emerging industries, and a city with a bright future

Through its membership, The Chamber feels it can identify and provide valuable insight into currently held perceptions and concerns for Manitoba's future, as well as potential solutions. We are therefore pleased to present this submission on behalf of our 2,100 member companies that employ over 90,000 men and women in the City of Winnipeg.

Introduction

On July 18th, 2017 Finance Canada released the consultation document *Tax Planning Using Private Corporations.* The paper focused on three issues that Finance Canada believes high income individuals are using to gain tax advantages. Upon release in the middle of summer, the federal government provided a meager 75 day consultation period to solicit feedback on the proposed changes.

Small Business the Engine of the Economy

There are over 1.1 million employer businesses in Canada. Almost 12 million Canadians work in these businesses, which constitutes around two thirds of all employment in Canada. Of these businesses, 97.9% are small (1-99 employees), and 1.8% are medium (100-499 employees) in size. As the below chart illustrates, over half of all businesses Canada have between 1-4 employees, and almost three quarters of all businesses have fewer than 10 employees.

Number of Employees	Cumulative Percentage of Total Businesses in Canada
1-4	54.1%
5-9	73.5%
10-19	86.2%
20-49	95.1%

These small businesses are the retail shop owners, farm families and tradespeople of this country who are responsible for the majority of employment growth. Together, small businesses are responsible for over 70% of the private sector employment in Canada; medium businesses constitute another 20%.

Together, about 90% of all private sector jobs are with small and medium sized companies, forming the majority of all jobs in this country.

Small businesses are the biggest drivers of employment growth in this country. From 2005-2015, private sector businesses contributed an additional 1.2 million jobs in Canada. Over a million of those jobs (87.7%), were created by small businesses. The 2008 financial crisis severely impacted all businesses, but especially small and medium sized ones. Since the financial crisis, they have come roaring back, as small and medium businesses created almost 850,000 jobs from 2010 to 2015. In 2013 for example, small businesses added over 170,000 jobs, constituting all of the private sector employment growth in Canada.

Instead of being supported, these small businesses often bear the brunt of government regulation and changes. From Canadian Pension Plan and Employment Insurance increases to the uncertainty around the cost of the federal carbon tax, small businesses are already facing added costs and uncertainty in the years ahead. Going ahead with these changes will be detrimental to their viability, just at a time when they need more support not less. In 2013, over 78,430 small businesses were started in Canada, while 83,240 ceased operations, for a net loss of over 4,800. That is an extremely worrying statistic especially considering almost 90% of all private sector employment gains come from those small businesses.

Taxing Risk-takers and Community Builders

It is important to recognize the amount of risk that a small business person takes on as compared to that of an employee. From the time they open up, they immediately take on risk. They already have expenses and fixed costs to pay before that first client comes through the door.

Most small businesses have at least one loan, if not multiple loans. Savings and retirement accounts are often used, or emptied in some cases to start the business. The family home can become mortgaged and re-mortgaged as well in order to start up.

Small business owners not only support their families, but they also support the families of all their employees by paying their employees' wages. Unlike their employees, small business owners don't get vacation time, unemployment insurance, a pension plan, severance, paid overtime or maternity benefits. There are no steady paycheques for entrepreneurs, only the steady stress of making payroll.

Small business owners face long hours, and starting out they are the last to earn an income, if they earn any income at all. Running a business and being an entrepreneur is a 24/7 task, and these proposed changes have added another major worry onto already burdened entrepreneurs.

Almost half of all Canadian businesses fail within the first five years of being started. Around 30% don't survive their first two years, and close to 40% don't continue beyond their first three years. The chart below underscores just how hard it is keep a business running in Canada:

Survival Rates for Canadian Businesses with less than 250 employees	
First Year	85%
Second Year	70%
Third Year	62%
Fifth Year	51%

Proposed Tax Changes

The impact of these proposed changes will be far reaching, and they will dampen entrepreneurship and severely negatively impact the job creators of our economy. The changes:

- **Reduce the use of "income sprinkling in private corporations:**

This refers to business owners dispersing income to family members by distributing dividends. There are currently rules in place around income splitting with minors, which prevent these transfers by taxing several types of income to minors at the highest marginal personal tax rate. The proposed changes are meant to expand that regime by applying the tax on split income to any family member regardless of age if the split income is deemed unreasonable. The test will be much stricter for individuals aged 18-24, but for all family members it will be based on labour and/or capital contributed to the business.

Finance Canada expects to raise $250 million by applying a higher tax rate on this "unreasonable" compensation of family members. This would require CRA to tax $1 billion of salaries/dividends and audit hundreds of thousands of businesses. The draft legislation would put these restrictions in place come January 1, 2018, which is less than three months away.

For example, if a spouse is paid $50,000, but the CRA assesses the value of his/her contribution at $20,000, how should a business owner prove the value of the contribution? Or if a couple owns a restaurant for 30 years and pays themselves $40,000 annually in dividends. If one spouse reduces their hours worked because of aging, do they trigger a higher tax rate because of their reduced labour contribution? In addition, how do you determine what is the reasonable rate of return for a restaurant? Should you look at the return on investment of similar restaurants, of small businesses in the region, or the success rate of first-time entrepreneurs?

Investors can earn generous returns from public companies, but Canadian private companies will be required to show reasonable labour or capital contributions. These changes would make for an un-level playing field for private and public companies. In addition it is important to note that these changes are only at Canadian controlled private corporations, given advantages to foreign owned corporations.

Many businesses receive their first capital from friends and family. These "reasonableness" tests could trigger a much higher tax rate on dividends paid to family or "connected parties" if the labour, the capital contribution or the rate of return is not deemed "reasonable."

Declaring dividends to a spouse recognizes the financial contribution made with family money into a business and it also recognizes the labour put in by a spouse to support the business. The labour portion can be seen in almost every small business where the spouse supports by acting as an advisor, sounding board and source of labour. In addition many businesses are started with family money that was earned by spouses. That money would have otherwise gone into an RRSP, which would make it tax free and eligible to be split with the spouse after age 65. If the intent is to make the playing field equal, why shouldn't you be able to buy a business with the same tax rulings as one gets with a RRSP?

- **Restrict the use of private corporations for making passive investments:**

Currently, passive (investment) income is taxed upfront at a rate of 50.3%. This is refundable when an investor withdraws it from the business because they will pay personal tax rates. The proposed changes make the 50.3% tax non-refundable, and additional taxes would be paid when income is paid out to shareholders, making the effective rate climb to over 70%.

Taxing business savings at 73% means there is no incentive to keep money inside the company, and business owners would be better off by taking money outside their business. **Canada would become the only advanced economy in the world to tax passive income like this in a business.** Why would an investor want to invest in Canada, when across the border or in other jurisdictions, he or she would not face such taxes?

There are strong economic reasons to encourage business owners to accumulate a surplus asset cushions in their businesses. It allows them to make capital investments or to weather economic downturns such as the financial crisis. In 2008 during the financial crisis, there were over 30,000 more business exits than starts in Canada. If businesses can't hold rainy day funds, how many more exits would there have been? As data shows that almost 90% of all private sector job growth comes from small businesses, reducing reasons to invest in their business will not help job growth.

- **Restrictions on capital gains:**

These changes will be devastating for many small business owners. These changes will block "pipeline transactions", and make it significantly more advantageous on death to sell a business to a third-party than pass it onto one's children. The tax burden for transferring to one's children would become almost twice as high as transferring the business to a non-family member. This will impair the ability of businesses to get passed on from one generation to the next.

Shares held by trusts will no longer be eligible for the capital gains exemption. Therefore, if a family trust with four adult beneficiaries sold its shares in a family corporation for $4 million, these tax increases would mean the family unit would be paying an additional $671,000 in taxes. Moreover holding shares in a family trust is an extremely common planning technique for small business owners. It will be extremely expensive in terms of time, legal and accounting fees for many small business owners to review their family trusts and determine what to do with the shares in same. They will potentially need to wind down their trusts. This could result in the shares held by the trust being distributed to family members of the business owner prematurely.

The proposed legislation would make these changes retroactive to July 18, 2017, the same day the consultation document was released. Family businesses have been working on succession planning for decades in some instances, and the rules have been in place for the same amount of time. Through this proposal you are going to change the rules overnight, increase taxes, and disincentive them selling to their children.

The cumulative impact of these changes will be severe, and cannot be understated. These changes will:

- Unfairly prevent small business owners from building up retirement savings;
- Lead to lower savings within their businesses, eroding sustainability and future investments for business growth;
- Make it more difficult to pass down ownership of family-run businesses to the next generation;
- Result in more intrusive, costly audits by the CRA.

The business community is facing a host of government induced cost increases in the near future in addition to these changes. These range from Canadian Pension Plan and Employment Insurance increases, plus the effect the new carbon tax. In addition the promised cut in the small business tax rate from 11.0% to 9.0% appears to be off the table. The reduction to 10.5% has been a big boost for small business, and we applaud the government for that action. As outlined previously, these are the job creators of the country, and government needs to support them, instead of add on costs.

Recommendations:

The Winnipeg Chamber of Commerce is unequivocal in our opposition to the proposed changes as outlined in the Tax Planning Using Private Corporations document. Further, The Chamber recommends that the federal government:

- cease immediately any continued use of class-based language and communications aimed at driving division between Canadians and undermining Canadians' appreciation for the role of small and mid-sized business in our economic prosperity;
- announce immediately an extension to the current consultation period slated to end October 2, 2017;
- present clear and transparent economic modelling which demonstrates the various impacts of the proposed changes; and,
- establish a Federal Tax Review Commission mandated to review the entire federal tax system, commencing with business taxation. Such a review has not been conducted in many decades, and in its absence, we have seen a proliferation of patchwork tax policy. The entire system needs to be examined, with proper time for consultation from all Canadians, in addition to presenting various options that need to include economic modelling of the different impacts.

References

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- *Tax Planning Using Private Corporations.* Department of Finance Canada, 2017. https://www.fin.gc.ca/activty/consult/tppc-pfsp-eng.pdf