The Private Corporation Tax Proposals – A Reflection of the Last 9 Months (And Where Do We Go from Here?)

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Well, the last nine months have been a hell of a ride. I've never experienced anything like it and I hope I never do again. I've seen some of the worst forms of politics influencing tax policy that I ever could have imagined (but I'm a tax geek and my main interest is helping out private corporations and their shareholders navigate their tax affairs). I am by no means a politician and I have zero interest in becoming one. However, surely Canada can do better than what we experienced?

Let's take a stroll down memory lane, shall we? It all started on July 18, 2017. On that day, Minister Morneau released some of the most ill-conceived and technically sloppy proposals to try to reform approximately 50 years of Canadian private corporation tax policy – and he announced a 76-day "consultation period" that would end on October 2, 2017. Such proposals were cloaked around misleading language of "fairness," "fair share," and "loopholes" in the Minister's letter attached to the proposals. Such a letter was a classic class-warfare manifesto that was so unnecessary and disappointing. The messaging left many business owners and their advisors feeling as if they were being called tax cheats with virtually all of them being proud Canadians who diligently—to the best of their abilities—follow Canada's tax laws and pay their "fair share" (read: "legal amount owing") of taxes.

Thankfully, many tax practitioners and some tax academics started to educate the public on the damaging effects of the proposals. The Coalition for Small Business Tax Fairness was formed after numerous meetings, phone calls, emails and other communications amongst concerned parties. In addition, some very prominent entrepreneurs and Canadians formed The Council of Progressive Business Leaders and posted an open letter to the PM and encouraged people to sign a petition available at its newly formed website: www.wtfjt.ca .

The government then went into defence mode and started using various social media outlets as propaganda machines; for example, have a look at the Department of Finance's Twitter account from August 2017 onwards where there were cutesy graphics, videos and other communications used to defend the proposals all in the name of "fairness." The government also released very misleading information. In the late summer and early fall of 2017, I started documenting some of the misleading statements in a "Myths vs. Facts" document. Every time I look at my collection, I cringe. The backlash against the proposals was tremendous, and rightly so. While some parties supported the proposals, such defences did not appear grounded in a clear understanding of tax policy or the technical proposals themselves. Instead, in my opinion, most of the defences were pure politics.

After the "consultation" period ended, the government started to climb down with its "Santa Clause" week of announcements. Our firm wrote about such announcements here. From the end of "Santa Clause" week to December 13, 2017, things were rather quiet while the tax and business community were in waiting mode. We were waiting for version two ("V2") of the "income sprinkling" proposals and for the 2018 Federal Budget so as to see what the passive income proposals would look like. On December 13, 2017, V2 of the income sprinkling proposals were released. While a bit better than V1, the second version was still overly complex and full of technical concerns. Our firm wrote about V2 of the

income sprinkling proposals here and provided a flowchart here. On March 8, 2018, the Joint Committee on Taxation of the Canadian Bar Association and CPA Canada made a submission to the Department of Finance regarding V2 of the income sprinkling proposals. The Joint Committee submission is certainly worth a read to absorb its overall concerns about the complexity and many technical issues that are present with the proposals. It's also interesting to note that the government originally estimated that the the July 18, 2017 income sprinkling proposals would raise government revenues by approximately $250M per year. However, the Office of the Parliamentary Budget Officer ("PBO") released its report on March 8, 2018 and, well, suffice it to say that the PBO struggled with deciding on the methodology on how to estimate the tax increases, but ultimately under all scenarios, the estimated tax increases are significantly more than $250M per year.

On February 27, 2018, the Federal Budget was released. The original passive investment proposals were effectively dropped and instead replaced with a grind-down of the small business deduction ("SBD") to the extent a Canadian-controlled private corporation ("CCPC"), including "associated" corporations, earns more than $50K of passive investment income (with a modified proposed definition of what such passive investment income will entail). We wrote about such proposals here.

So, where does all of this leave us? Well, let's attempt a quick summary of the original July 18, 2017 proposals and where we are now:

1. "*Income Sprinkling*" – V2 released. The Joint Committee has commented on its concerns. If passed into law, such proposals will have application January 1, 2018 forward.
2. *Restriction of Capital Gains Deduction for Minors and Multiplication* – The "Santa Clause" week of announcements opened up the door for capital gains deduction multiplication again. V2 of the income sprinkling proposals enable minors to claim capital gains deduction on qualified small business corporation shares and qualified farm or fishing property.
3. *Surplus Stripping Proposals* – The "Santa Clause" week of announcements completely abandoned all of these proposals. The government has committed to try and improve long-standing issues regarding the transfer of businesses to family members that often are not as tax preferential as compared to transfers of businesses to arm's length parties.
4. *Passive Investment Proposals* – The 2018 Federal Budget abandoned the punitive "penalty tax" regime in favor of a grind-down of the SBD for CCPC – and associated corporations – that earn more than $50K of certain passive income.

Pending any further changes with V2 of the income sprinkling proposals and the amended passive investment proposals, the July 18, 2017 proposals are a whimper of what they started out as. Don't get me wrong, the income sprinkling proposals and the passive investment proposals are still problematic; but most practitioners are simply relieved that the original passive investment proposals will not be proceeding. So, this leaves me wanting to talk about two topics: a) what should business owners and their advisors now consider after the nine-month debacle; and b) how could this mess have been avoided, and what should the next steps look like?

A. What Should Business Owners and Their Advisors Now Consider?

In my opinion, here are some things that private business owners should now consider:

1. *Income Splitting* – there are still many good income-splitting strategies available. So-called "prescribed rate" loans to spouses/common-law partners or certain carefully drafted trusts can be good ideas (but it will be an even better idea if the loan is completed before April 1, 2018 since the prescribed rate is scheduled to increase on that date). Paying reasonable salaries to

family members is still an effective plan. What about paying unreasonable salaries to family members and self-assessing such unreasonableness (by not deducting and disclosing the unreasonable amount)? Would such a plan make sense or are there are other risks, such as shareholder benefit risks, to consider? Opportunities to multiply the capital gains deduction, and perhaps even crystallizing it, should be considered. And, depending on the ultimate final version of the "income sprinkling" proposals, careful navigation of those rules should be completed so as to explore opportunities.

2. *Salary/Dividend Planning* – this is a very basic function of most general practitioners who advise family businesses with CCPCs. What amount of salary should the business owner receive? How much dividend income? The answers often depend on the cash needs of each family and there are no obvious black and white answers. However, in my opinion, most business owners should cover off the basics. One of the basics is ensuring that family members can contribute to an RRSP and build up Canada Pension Plan ("CPP") pensionable earnings. The only way you can achieve both RRSP and CPP pensionable earnings is ensuring that the business owner has "earned income", which generally means salary. Too often I see situations where a business owner of modest means is solely remunerated by way of dividends with no salary. Such persons will thus not be able to contribute to an RRSP and ultimately this affects those persons' CPP benefits in a negative way. Not good. Having a good salary/dividend mix from their CCPC should cover off RRSP contribution and CPP pensionable earnings entitlement.
3. *Maximize Tax Deferral* – now that the original version of the passive investment proposals have been abandoned and tax integration on such passive income has been maintained, business owners should continue to seek opportunities to defer income in corporations. Let's be clear – there is nothing wrong with such deferral notwithstanding the recent misguided proposals put forward by the government. In order to avoid the application of the new grind-down of the SBD, consideration should be given – after receiving good investment and insurance planning advice – to having the CCPC acquire investments that enable deferral of capital gains and investing in the tax exempt account of certain life insurance policies (if there is an underlying need for life insurance to begin with). In addition, would it make sense to have the CCPC take a more active role in the trading of their otherwise passive portfolio so as to have any realized capital gains be treated as account of income? While the treatment of gains could be taxed on account of income thus avoiding the grind-down of the SBD, there may be an overall tax increase associated with such treatment. A mathematical and factual analysis would need to be carefully considered in each scenario.
4. *Use Retirement Compensation Arrangements "(RCAs") or Individual Pension Plans ("IPPs")?* During the last nine months, when business owners and their advisors were concerned that the passive investment proposals would result in a punitive tax regime, many advisors suggested that future profits – and perhaps some existing surplus – could be reduced or eliminated by using RCAs or IPPs. I wrote about RCAs in this 2013 Canadian Tax Foundation paper. As a quick reminder, an RCA is a trust that is established to provide retirement benefits for employees of the business. Contributions made to an RCA are deductible by the corporation, but the RCA is subject to a 50% refundable tax on such contributions (and future investment income of the RCA trust). The refundable tax is refunded by the CRA in the amount of $1 for every $2 withdrawn from the RCA to the employee beneficiary. The employee beneficiary of the RCA will then pay income tax when he/she receives RCA benefits. First off, I was not – and still am not – convinced that contributions by a CCPC to an RCA is a magic bullet to avoid the passive investment proposals. Such contributions must be for the retirement of the employee and – like all expenditures – are subject to a reasonableness test. In my opinion, RCAs can be useful in the right circumstances but the loss of investment yield on the refundable tax portion held by the CRA (the CRA does not pay interest on the refundable tax held) and the reasonableness issues must be considered carefully. IPPs are defined benefit pension plans for an individual.

Contributions by the CCPC to the IPP are deductible by the corporation and not included in the income of the individual beneficiary. In many cases, the amount that can be contributed to an IPP is greater than what would have been otherwise available with a traditional RRSP. However, there are additional costs associated with an IPP – like actuarial and reporting matters. In addition, the IPP assets are generally more difficult to access as compared to a traditional RRSP. While it is often worthwhile to explore the pros and cons of the use of an IPP in each circumstance, it is my opinion that IPPs are not a one-size fits all solution.

5. *Eliminate CCPC Status* – the current integrated taxation treatment of passive investment income applies only to CCPCs. If a non-CCPC earns passive income, then the taxation of such income is taxed at the general corporate rate – and one-half of that for capital gains – but ultimately a level of deferral might be achieved since there may be the ability for the corporation to hold onto the funds and not pay out the after-tax funds as a dividend to the shareholder(s). In some cases, it may be easy to achieve non-CCPC status by having the controlling shareholders become non-residents of Canada. In other cases, it may be more difficult and may carry some risk. Notwithstanding, business owners should consider whether having a CCPC is tax effective and if there are opportunities to own non-CCPCs.
6. *Become Non-Residents of Canada* – let's be clear…..I'm a proud Canadian. But when Canadian business owners have been attacked the way they have been, many business owners have considered leaving Canada. I've stated it many times and written often about this: the amount of capital leaving Canada is staggering. And, it's hard to argue against the financial reasons, especially when our current federal government – and many of Canada's provinces – have asked the so-called 1% to "pay just a little bit more" by significantly increasing personal tax rates, and by implementing other anti-business policies laced with corresponding offensive rhetoric. While Canada has a "departure tax" that applies to persons who become a non-resident of Canada, paying such a departure tax may often be worthwhile in the long run. On top of that, other countries offer incentives for people to immigrate to their country. For example, the UK has a 15 year tax holiday on certain foreign income. Israel has a 10 year tax holiday on certain foreign income. Italy has recently introduced similar incentives. Hong Kong does not tax investment income. The UAE does not tax at all. Barbados has no tax on foreign lifetime income. And let's not forget the largest market in the world that has just completed landmark and historical tax reform – the US. Such tax reform has made Canada – in a very short period of time – not tax competitive. Our government is not responding to US tax reform, but is instead "studying" it. Very disappointing. Should business owners or people with wealth consider leaving Canada in order to maintain/maximize their wealth, or to enhance competitiveness? The short answer is obvious. Yes.

B. How Could The Mess of the Last 9 Months Been Avoided and What Should Next Steps Look Like?

I think there was a very easy way that the debacle of the last nine months could have been avoided. If the government had simply involved the tax and business community in its proposals well before they were released to the public, we would likely not have experienced the mess that we did. Instead, it appears that the government only initially involved certain tax academics, economists, politicians and bureaucrats. The obvious parties missing were tax practitioners and the business community which are people who have to actually apply the rules to real life situations. In the future, any attempt to transform existing Canadian tax policy should involve true engagement from all affected stakeholders. I realize my next wish is likely fantasy, but it should also be free of political interference and influence. While the government of the day is free to do what it wishes with respect to changing tax policy and legislation, transformative change – for better or worse – should ideally involve all stakeholders and expertise that is not influenced by simple vote grabbing attempts.

While politics will likely get in the way of comprehensive tax reform, I agree with the Report of the Standing Senate Committee on National Finance of December 2017 – *Fair, Simple and Competitive Taxation: The Way Forward for Canada* – where it recommended:

> "That the Government of Canada undertake an independent comprehensive review of Canada's tax system with the goal of reducing complexity, ensuring economic competitiveness, and enhancing overall fairness."

An independent and comprehensive review of Canada's tax system is long overdue. Practitioners have been calling for it for well over a decade given the fact that the last comprehensive review of Canada's tax system was completed in 1966 by the Carter Commission. While the Carter Commission's Report has aged very well, there is no doubt that our system needs another comprehensive review. And to be fair, there were certain elements of the July 18, 2017 proposals that represented good tax policy changes. Unfortunately, the offensive rhetoric, sloppy technical issues, and awful messaging clouded any good policy changes that did exist.

More important, though, is that the awful experience of the last 9 months has caused a very significant distrust between the government and the tax and business community. I would respectfully suggest that most of the distrust exists at the political level, but certainly some does exist at the bureaucratic level as well. For me, I greatly respect many of the bureaucrats at the Department of Finance. Most are very dedicated to Canada and ensuring that our tax system "works." However, there is no doubt that the experience of the last 9 months has not been good. It is hoped that transparency and openness will be the norm for the future.

After the 2018 Federal Budget was released, a respected and prominent Globe and Mail columnist wrote the following:

> After enduring months of condemnation from angry doctors, accountants and other small-business owners, Bill Morneau's latest small-business tax plan has successfully quieted some of his loudest critics.

I take a different view. Most of the critics of the July 18, 2017 proposals are still very concerned about what's remaining: V2 of the income sprinkling proposals and the revised passive income proposals; but we're relieved that the government backed down from most of the sharp edges of the July 18 proposals. The distrust that remains between the tax and business community and this current government won't easily disappear. The memories are long. But, a true attempt to engage in a comprehensive and independent review of Canada's tax system might go a long way to mending fences. Until that happens, expect the loudest critics to likely not speak up as often; but trust me…..we have long memories and still have the energy to speak up for the benefit of Canadians as a whole. Not just for the middle class; or whatever identity is the subject of the current government's divisive identity politics.