HENDRY WARREN LLP
CHARTERED PROFESSIONAL ACCOUNTANTS

Ian W. Hendry, CPA, CA, CFP
Ext. 223
ian.hendry@hwllp.ca

200-881 Lady Ellen Place
Ottawa, ON K1Z 5L3
(613) 235-2000
www.hwllp.ca

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The Honourable Bill Morneau
Minister of Finance
House of Commons
Ottawa, ON K1A 0A6

Dear Mr. Morneau:

Re: Tax Planning Using Private Corporations: A Fair Proposal?

In your letter of July 18th, 2017 to Canadians you presented proposals which by your own admission are complex, yet designed to help businesses grow, create jobs and support communities. Your core message is fairness of the tax system, a word repeated many times throughout the document.

This letter argues that these proposals will have the opposite effect on business and that at their core they are not fair when considered in the context of other groups of taxpayers. Employment and investment will decline, charitable donations may be reduced and the "brain drain" of professionals to the US and other jurisdictions will accelerate.

What is fairness? Accepted definitions of the word include impartial and fair treatment without favouritism or discrimination. Expressed another way, it is a quality of treating people equally or in a way which is right or reasonable. I believe that the proposals of July 18th, 2017 fall far short of these standards.

We appreciate that developing tax policy is a difficult and unpopular task. Nonetheless, the principle of fairness must be an unwavering goal recognizing the technical challenges of drafting appropriate legislation.

Before proceeding to our assessment as the fairness of your proposals, let me speak to the fairness of the manner in which these proposals were delivered to Canadians.

Ian W. Hendry, CPA, CA, CFP
Daniel B. Warren, CPA, CA, TEP
Marie Fraser, CPA, CA, CFP
Nancy Nicks, CPA, CA
Jacob Milosek, CPA, CA
Blair Duffy, CPA, CA

MEMBER
INPACT
INTERNATIONAL ALLIANCE OF PROFESSIONAL ACCOUNTANTS

Substantive changes in tax policy are typically the subject of a Federal Budget announcement. Such announcements are well publicised in advance, released while the House is in session, and delivered by the Minister of Finance in a speech to all parliamentarians and Canadians. This speech is broadcast by public and private broadcasters with reaction of tax experts, economists and special interest groups available to the public to provide different perspectives on any changes. The opposition parties have an opportunity to comment on the proposals and offer their assessment to their constituents.

In short, a better-informed public and an opportunity for dialogue and debate results from this time-honoured approach.

As a tax practitioner for over 30 years I can confidently say that the proposals of July 18th, 2017 are some of the most sweeping and dramatic I have ever seen.

Was the manner in which the Department of Finance released these proposals fair and is the comment period adequate? I would argue no in both respects. To have answered these questions in the affirmative I would have expected the following to have occurred:

- That media outlets and the public would have been advised well in advance of your speech to provide an opportunity to assemble experts to review and comment on the proposals. To my knowledge CPAC and Facebook were the only carriers of your presentation and there was no live feed on CBC or private broadcasters;
- That changes of this magnitude would have been announced when the House is in session. The delivery of sweeping tax changes which contain very controversial provisions when Parliament is in recess thwarts rebuttal and effectively reduces exposure of the measures which is not right or reasonable;
- That a longer consultation period would be made available. A 75-day consultation period is unreasonably short given the timing and manner of the announcement when many commentators and parliamentarians were away on summer holiday.

Legislation continues to be built providing the Canada Revenue Agency with an increasing level of interpretative powers. The predominance of phrases such as “reasonably be considered” and “reasonable to conclude” throughout the draft legislation increases uncertainty for taxpayers and opens the door to abuse by taxation authorities.

Would a taxpayer or their advisor conclude that the method of your announcement could “reasonably be considered” fair? I think that answer is definitely not.

In the democratic society that we have in Canada, future announcements of this magnitude must only be made when the House is in session where the full scrutiny of all Canadians can be brought to bear on them. Further, I believe that the consultation period should be extended to allow the public at large to make their views known.

Moving to a discussion of the tax proposals themselves, it is important to consider the role and conditions under which small and medium enterprises operate in Canada.

These factors are important in forming an opinion as to what is fair in light of the proposals and accompanying draft legislation:

- Small enterprises account for 97.9 % of business entities in Canada[1];
- 54.1 % of enterprises have fewer than 4 employees[1];
- Small businesses employ 8.2 million people or 70.5% of all private sector employment[1];
- 87.7% of net employment between 2005 and 2015 came from small business[1];
- In 2013 while there was the “birth” of 78,430 new businesses there were also 83,240 “deaths” [1];
- Over 80% of start-up enterprises were funded with personal resources[1];
- 51.3% of small and medium enterprises rely on credit from financial institutions[1] ;
- 80.4% of employees in the public administration sector have a Defined Benefit Pension Plan (DBPP) compared with 24.3% (men)and 32.6% (women) in all sectors including public administration[2];
- 84.9% of employees in the public administration sector have some form of pension plan versus 35.6% men and 41.2% women in other sectors[2];
- Pension splitting is estimated to have cost $ 1.7 Billion in reduced tax revenues in 2015[3];
- 7 out of 10 senior families get no benefit from pension splitting[3];
- The richest 10% of seniors receive tax benefits that are more than the bottom 70% combined[3];
- 47% of Canadians aged 55-64 have no accrued employer pension benefits[4];
- The median retirement assets of Canadians aged 55-64 is just over $ 3,000[4];
- Proposed dividend sprinkling measures would add revenues of $ 250 million when fully implemented[5];
- In the 2014-2015 fiscal year the Voluntary Disclosure Program reported the disclosure of $1.3 Billion of previously unreported income[6];
- The average life expectancy for men in Canada is 80 and 84 for women[7]; and
- 64.7% of businesses are majority owned by men with 15.7% majority owned by women[1].

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[1] Key Business Statistics – June 2016. Industry Canada www.ic.gc.ca/sbstatistics
[2] Statistics Canada – Insights on Canadian Society New facts on pension coverage in Canada December 18, 2014 http://www.statcan.gc.ca/pub/75-006-x/2014001/article/14120-eng.htm
[3] Canadian Centre for Policy Alternatives (CCPA) Authored by Senior Economist David MacDonald January 18, 2014
[4] Study by the Broadbent Institute February 2016
[5] Page 15 – Tax Planning Using Private Corporations, Department of Finance July 18, 2017
[6] Canada Revenue Agency Report to Parliament June 2016
[7] World Health Organization Statistics, 2014

What can we conclude from these facts?

- Small businesses are a critical component of our economy.
- Most small businesses are indeed small (fewer than 4 employees).
- Capital generated by businesses is needed for expansion by a majority of entities.
- Most entrepreneurs do not have a pension plan whereas the overwhelming majority of public sector workers do.
- The mortality rate for small businesses is significant.
- Dividend sprinkling as a means of splitting income costs the treasury about $ 250 million a year. Pension splitting (another form of sprinkling) is 7 times larger at $1.7 Billion per year.
- More effort to collect tax on unreported income is a more productive process of raising revenues.

THE UNFAIRNESS OF INCOME SPRINKLING PROPOSALS

The cornerstone argument made by your department about income sprinkling is that it can reduce income taxes of high income earners by distributing income to lower income individuals.

The arithmetic results of income sprinkling cannot be argued. However, in referring to the matter of fairness, is that group being treated favourably over others?

As mentioned previously, pension splitting which is enshrined in our tax code allows pensioners to save $1.7 Billion a year according to recent estimates. With an average life expectancy of over 80 years for men and 84 for women, a person retiring at 65 can enjoy 15 years of this benefit. Under your proposals a retired entrepreneur cannot split his or her retirement capital in a similar fashion.

Comparatively speaking, the income sprinkling rules target a much narrower segment of the population and specifically young people from ages 18-24.

As for the sprinkling of the Lifetime Capital Gains Exemption (LCGE), recall the statistics noted previously that 80% of start-ups use family resources to do so. In such circumstances, why should only one family member (predominately male) be permitted to use the exemption when family assets have been put at risk?

So, as a matter of fairness, if the goal is to level the playing field shouldn’t those with pensions be drawn into the rebalancing?

THE UNFAIRNESS OF THE PROPOSED PASSIVE INCOME RULES

The July 18th, 2017 proposal paper states that holding passive investment assets in a private corporation may be financially advantageous for the owner of a private corporation over other investors.

Once again, while the example Tables are arithmetically correct, they don't begin to tell the whole story. Using some of the facts outlined earlier and observations from our practice, let me describe the reality for most small and medium sized enterprise owners:

- Investments which appear passive may in fact be providing support to business operations, may be required by a lender, may be a source of retirement capital, may be held pending an investment opportunity or for capital acquisitions, or a combination of all of these factors.
- It has been a best practice whenever possible to isolate investment assets in a holding company to protect them from creditors. This opportunity has been curbed in recent times due to the operation of subsection 55(2) of the Income Tax Act.
- Unlike those who have a DBPP, no one other than the entrepreneur is contributing to retirement funding. Benefits available under DBPP's often exceed what is available to entrepreneurs using Registered Retirement Savings Plans. This gap referred to as the "pension shortfall" must be made up somehow, typically in the retention of corporate earnings.
- Unlike a DBPP which grows on a tax deferred basis, growth of portfolio investments is taxed on an annual basis at the corporate level.
- Unlike a DBPP which allows for pension splitting at retirement, the proposals of July 18th cast doubt on whether a retired entrepreneur could split income with a spouse who has been a shareholder since day one. The retirement of many business owners who saved for retirement under existing tax rules is in jeopardy as a significant portion of their retirement assets will now be clawed back by higher taxes. This form of retroactive legislation deprives them of the right to plan their retirements with certainty. Clearly different treatment.
- Unlike a DBPP which allows the earnings on employer and employee contributions to be taxed at rates which are lower in retirement, the proposals for corporate shareholders suggest that ongoing income be taxed at rates well in excess of 50%.
- The complexity of tracking various pools of capital and the related compliance costs for small business owners will be substantial.
- The compliance and enforcement costs of such unwieldy proposals combined with the prospect of considerable litigation should not be underestimated.
- The high mortality rate of small business suggests that capital is more often insufficient than excessive.

Once again, fairness is a concept which should be used broadly and not narrowly. True tax fairness would address inequities in the following ways:

- Should a form of the current proposals be implemented, RRSP limits should be increased substantially. Further as dividends are an alternate form of compensation, the definition of earned income should include dividends from private corporations.
- Alternatively, a threshold of acceptable passive capital should be permitted based on a proportion of total assets.
- Corporations should be permitted to determine pension shortfalls and mitigate them with increased RRSP limits, or self-funded pension plans.
- Existing wealth in private corporations should be grandfathered such that it can be distributed to spouses to fund retirement and taxed at graduated rates. Such a fresh start rule is necessary to provide business owners who accumulated corporate wealth under existing tax rules certainty that they will have sufficient funds to finance their retirement. This would be consistent with the taxation relief provided in the capital gains exemption and passive income proposals.
- The best option however would be to maintain the status quo recognizing that capital can be required sporadically and unexpectedly to fund operations. Well capitalized companies will be more successful, stable and taxable.

THE UNFAIRNESS OF PROPOSED RULES TO CONVERT CERTAIN CAPITAL GAINS INTO ORDINARY INCOME

The incentive to convert dividend income to capital gains is a circumstance almost entirely created by the Federal Department of Finance. In Ontario today, (for a top tax bracket taxpayer) a dollar of capital gain attracts about 27 cents of tax whereas a dollar of dividend income attracts 45 cents of tax.

From the time of the Carter Commission in 1966 a fundamental principle of tax policy theory is that these rates should be approximately equal.

Reductions in corporate tax rates have been touted by successive governments both Liberal and Conservative as evidence of support for small business.

Absent from these good news stories has been the corresponding increase in tax rates on dividends from small business earnings in particular. While the Federal corporate tax rate has fallen from 28% in 2000 to 15%, there has been a surge in personal tax rates on dividends.

Essentially, the increase in personal tax rates has been a “trap” for those entrepreneurs who retained profits in their corporations. These entrepreneurs who paid high corporate tax rates in the past are being subjected to higher personal rates on dividends a second hit. These changes are effectively retroactive in their application changing the rules mid-stream.

By not providing an equalization system (which admittedly would be very complex) the Federal and Provincial governments know full well that they are benefitting from this windfall. Once again would a reasonable observer conclude that the targets of these proposals have been treated fairly?

A particular example of a substantial inequity is related to the death of a shareholder/taxpayer. As you know where there is no surviving spouse, the death of a taxpayer creates a deemed disposition for tax purposes.

Public company shareholders have an open and liquid market for their securities permitting them to realize their investment through a capital transaction quite easily. Any gain is taxed at capital gains rates.

The death of a shareholder of a private company creates issues of liquidity and the prospect of paying dividend tax rates on their holdings. As an important aside with proposed amendments to section 84.1 and the introduction of section 246.1 some estates will be facing taxes on both capital gains and dividends as the affairs of the company are wound up.

Finally, the rules in subsection 84.1 severely restrict the intergenerational transfer of corporations. It is counter intuitive to think that our tax system provides an incentive to break up family owned enterprises. This is particularly of concern where a child is the only possible successor to carry on the business.

For a final time, we ask, are these proposals fair? Are they impartial? Do they discriminate? I believe that as currently presented all the wrong answers have to be given.

There are several remedies which we would ask you to consider to address these concerns:

- Sections 84.1 and 246.1 must be modified in a way to permit genuine inter-generational transfers on par with arms-length transactions.
- The offensive behaviour of a few is subjecting the entire corporate community to rules which are complex and punish those who have delayed the withdrawal of capital or died not having taken all their equity out. Transactions described in the tax literature as "pipelines" should be permitted under the same terms as accepted by Finance and the Canada Revenue Agency prior to July 18, 2017.
- The timeline permitted by subsection 164(6) to eliminate the prospect of double taxation on an estate is too short in the absence of the pipeline transaction. The 164(6) timeline should be extended from one year to three years.

As requested on page 17 of the Tax Planning for Private Corporations discussion paper, please be advised as follows:

- This submission is made on behalf of Hendry Warren Chartered Professional Accountants;
- We consent to the disclosure of our submission and would actively encourage its dissemination; and
- We do not wish you to reserve the identity of myself or our firm nor is any of the content of this letter considered to be confidential.

It is our sincere hope that the Department of Finance steps back from these proposals and carefully reconsiders them. This submission and those of our peers must be considered to ensure that fairness in tax policy be evidenced in fact not just in word.

Yours very truly,

Ian W. Hendry, CPA, CA, CFP

IWH/sd