Are the July 18, 2017 Tax Proposals and Subsequent Revisions Fair?

Since the release of the Proposed Tax Changes on July 18, 2017, Minister Morneau and Prime Minister Trudeau have continued to attack successful Canadian private business owners. They have said that these business owners have an **unfair** advantage over and above salaried employees because they have the ability to use their corporations to save for the future by making passive investments and to sprinkle income among family members.

"We understand that many, many small businesses are using their corporations to save for the future by making passive investments. For the vast number of corporations, this isn't a problem. But in a very small number of cases, it gives wealthy people an unfair advantage over and above everyone else."[1]

On December 13, 2017, Minister Morneau announced details around the income sprinkling measures.

After the announcement of these changes, Minister Morneau was interviewed and said these income sprinkling measures are *"Part of our goal in making sure our tax system is fair."*[2]

The Oxford Dictionary includes the following definition of fair, "The group has achieved fair and equal representation for all its members."

The Cambridge Dictionary includes the following definition of fair, "Treating someone in a way that is right or reasonable, or treating a group of people equally and not allowing personal opinions to influence your judgment."

Good tax policy should have two characteristics:

- It should be directional. It should encourage behaviour that supports the best interests of all Canadians. Canada needs innovation and entrepreneurship. Tax policy can play a key role in supporting this goal.
- It should have a high element of fairness.

The question with respect to these proposals and subsequent revisions is do they support innovation and entrepreneurship AND are they fair? By virtually every measurement, these policies are inherently unfair to Canadian private business owners and will discourage entrepreneurship and the retention of our best and brightest people. Although these proposals are directed at a very specific group (owners of Canadian private companies, especially companies in the service sector), it would be naïve to think the impact will not be felt by all Canadians.

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[1] October 18, 2017, CBC News
[2] December 13, 2017 Canadian Press

Here are four situations that demonstrate the failure of the federal government's tax policy in being directional and fair.

Situation #1
In the July 18, 2017 paper, Tax Planning Using Private Corporations, the federal government provided different examples where a business owner's situation was compared to a salaried employee. The examples provided situations where the business owner had an unfair advantage over the salaried employee because the business owner was able to pay less income tax due to the ability to income split with family members and/or retain earnings inside a corporation at much lower tax rates, thus allowing the business owner to accumulate more capital than a salaried employee earning the same income. The problem with these examples, as well as subsequent examples provided by Minister Morneau and Prime Minister Trudeau, was they only showed points in time or rare situations, and did not look at the full picture through a lifetime of the business owner.

In order to accurately determine if business owners have an unfair advantage, we have done the analysis that the federal government failed to do. You can see the analysis at our website (www.omg.ca). We provide three different scenarios where we compare a business owner to a salaried employee earning the same income. The same type of comparison the federal government made in their July 18th paper.

The conclusions all three scenarios came to was the same: the proposed rules, even after the changes announced the week of October 16 and on December 13, will give the salaried employee a huge advantage over the business owners. Capital available for retirement will be anywhere from **40% to 118%** more for the salaried employee, depending on the scenario.

Why such a large advantage for the salaried employee? The federal government only looked at the taxes paid at the personal level at a point in time and ignored other benefits the employee receives that business owners must pay for themselves in addition to their income. These additional expenses are material.

Is this the outcome the federal government is trying to achieve? If so, why and is this fair?

Even when compared to the current rules, the business owner is, at best, almost equal to the salaried employee.

The conclusion is clear; all business owners need be able to income split with spouses and accumulate passive investments inside a corporation without the proposed restrictions. The current rules (pre July 18 proposals) were well thought out. The current rules encourage business owners to be entrepreneurial and produce long-term financial results that are similar to salaried employees.

Situation #2

The December 13, 2017 announcement provided details on the income splitting proposals. Business owners will continue to be able to split with family members if the family member works on average 20 hours per week in the business or where a family member age 25 or older owns at least 10% of the company (value and votes). What is unfair about these proposals is that if the business is a professional corporation (PC) or 90% or more of the corporation's revenue comes from the provision of services (not defined), the business owner will not be able to split income with a family member, until the business owner reaches age 65, if they own at least 10% of the company's shares.

Why are PCs and the service sector being singled out and treated differently than other business sectors? The service sector is one of the largest in Canada. It certainly has some of the highest incomes and employs millions of people. PCs include medical doctors, dentists, chiropractors, veterinarians, lawyers and accountants. Service companies include plumbers, electricians, hair salons, engineering firms etc.

If a business sells dental supplies to a dentist, this business owner will be taxed more favourably than the business owner who fills the cavity or performs the root canal. If a business supplies orthopedic surgeons with artificial joints, this business owner will be taxed more favourably than the business owner who treats the patient and replaces the deteriorating joints. If a business supplies parts to a plumbing business, this business owner will be taxed more favourably than the business owner who fixes the leaks or installs bath tubs. If a business sells cow manure, this business owner will be taxed more favourably than the business owner who treats the cow in the event of sickness.

No explanation has been provided by the federal government for this unfair treatment.

The real question is does this tax policy encourage entrepreneurship in the service sector and are the long-term financial outcomes favourable in comparison to the salaried employee? The answer is a resounding NO.

Situation #3

The government's rhetoric on passive income is misleading at best. It has been suggested repeatedly that Canadian-controlled private corporations (CCPCs) pay tax on investment income at a **low rate**. The facts are that the **low rate** is between 50% - 55% (depending on the province) on the first dollar and every dollar of investment income. This rate is almost identical to the top marginal rate that high income Canadians pay. The next question is what tax rate do public companies like Loblaw, RBC and Morneau Shepell pay? Since most public companies are located in Ontario, the tax rate is 26.5% - **half** the rate of Canadian private companies. It also should be mentioned that foreign-owned private companies also pay tax at 26.5%. It is hard to understand why Canadian private companies would pay **double** the rate that foreign and public companies pay. It is our belief that the rate public companies pay is appropriate. We believe that the tax rate on investment income should be reduced for Canadian private companies to encourage business innovation and provide fairness amongst businesses operating in Canada.

What is truly hard to imagine is that the current proposal would increase the total taxes paid on investment income for Canadian private businesses to over 70%. Minister Morneau has said this proposal will affect only 3% of privately-owned businesses. Which 3%; the small, unprofitable business or the very best companies in Canada with the highest payrolls and largest number of employees? How does this pass the test of encouraging entrepreneurship and fairness with public and foreign-owned companies?

The outcomes of this proposal will be less capital available to Canadian private businesses as compared to their competitors. Also, the business owner will have less capital available for retirement as compared to a salaried employee making the same income.

What is fair about that?

Situation #4
Business owners made plans to fund their children's post-secondary education by following clearly defined rules that have been in place for decades. Effective January 1, 2018, these plans will be devastated. Almost 50% of the capital set aside for their children's education will be lost to higher taxes because they will no longer be able to income split with their children. These business owners are not able to go back and use RESPs. With a stroke of a pen, half their capital will be gone.

At a bare minimum, business owners who have relied on current rules to build up investments inside a corporation to fund children's education and split income with a spouse to fund retirement, should be grandfathered from these tax proposals. What the government is doing to these business owners is no different than if they said that effective January 1, 2018, Canadians can no longer use RESPs to fund their children's education. The federal government would not do that, so why are they making these proposed changes that would have a similar impact to business owners? This is a government that has clearly stated that supporting education is critical to the future of Canada. This tax policy directly affects the funding of education for many Canadian children.

How is this treatment fair?

Conclusion

The tax proposals fail miserably in encouraging entrepreneurship and in encouraging our brightest and best in wanting to remain in Canada, especially in the service sector. Based on the definition of fair, these tax proposals and subsequent revisions are clearly unfair. They target Canadian-owned private business owners and because they were introduced based on incomplete data and a lack of analysis, the outcomes are unfair. The question that needs to be answered is WHY?

- Why does the federal government believe that proposals resulting in salaried employees having **40% - 118%** more capital available at retirement than business earners making the same income is fair?
- Why is it fair to treat business owners, who operate as professional corporations or are involved in the service industry, differently than business owners in other sectors when it comes to being able to split income with a spouse?
- Why is it fair that Canadian private businesses are currently subject to tax rates (50 -55%) on passive income that are double the tax rates currently being paid by public and foreign-owned companies? Why does the federal government see the need to make something that is already unfair, much worse by proposing to grow the tax rate to over 70%?
- Why is it fair that business owners, who chose to provide for their children's education by income splitting instead of using RESPs, going to see the cost of paying for that education double? Why are there no grandfathering rules in place for them? All they did was follow the rules. Is that fair?

We are not suggesting tax reform is unnecessary. However, we do believe the Canadian Senate's recommendation to scrap these proposals and start over is the right thing to do. That should result in tax policy that encourages entrepreneurship and innovation, as well as, being fair to all Canadians.