WINNIPEG CHAMBER OF COMMERCE

Submission to Standing Senate Committee of National Finance: Study of the proposed changes to the Income Tax Act respecting the taxation of private corporations

October 31, 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, as well as for those who are older than 25. The reasonableness test the government is now proposing looks at whether a family member has made:

- Labour contributions to the business;
- Capital or equity contributions to the business;
- Taken on financial risks, such as co-signing a loan or other business debt; and/or
- Prior contributions in respect to any of the above three areas.

However much ambiguity remains around these income sprinkling changes. 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 what 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?

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?

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.

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 government has stated that a key principle for them in this process is to "avoid creating unnecessary red tape for hard-working small businesses". How is forcing small businesses to undergo more costly time consuming CRA audits possibly reducing red tape?

Currently these restrictions would come into place on January 1, 2018, which is only a couple months away. This doesn't leave much time at all for businesses to plan, and there is still a lot of ambiguity around these changes.

- **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?

The changes announced by the Finance Minister on October 18, 2017 are welcome, but will still limit the ability of small businesses so save for investment and growth. A passive income threshold of $50,000 is equivalent to a 5% return on a $1 million portfolio of savings. If you are a small business saving up to acquire a major piece of equipment to improve productivity, or you are saving up to buy another business, that $1 million won't get you very far. With that hard cap in place, as a portfolio increases in size, small business owners will be forced to put those savings into lower returning assets, or hold cash. Those lower returning assets mean it will take them even longer to save up to make major acquisitions, expansions or even retirement. The cap is an improvement, but it will still greatly hinder the ability of small businesses to grow.

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.

In addition, much ambiguity still remains around these passive income changes. More details are to be revealed in the 2018 federal budget, but when will these restrictions start? The now dropped capital gains restrictions were to start the day the original consultation paper was released. Investments already made and the income they generate are to be protected, but from what date? Businesses need certainty in order to invest, and that certainty is lacking when it comes to the final details of the timing around this proposal.

- **Restrictions on capital gains:**

The Winnipeg Chamber of Commerce was pleased to see the federal government drop the proposed changes to the Lifetime Capital Gains exemption, and with measures related to the conversion of income to capital gains. Those changes would have made it more expensive to pass a business on to the next generation, and we applaud the government for dropping them.

The cumulative impact of these changes will still be severe. 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;
- 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. The Winnipeg Chamber of Commerce was pleased to see the federal government return to their commitment to reduce the small business tax rate to 9%. As outlined previously, small businesses 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 pleased that the federal government made some changes to their original proposals. However the changes are still ambiguous in many areas, and the passive income changes will restrict the ability of small businesses to grow. The Chamber recommends that the federal government:

- pause any action on the reformed proposals, and instead engage in a longer consultation period. The original consultation period was only 75 days, and Finance Canada received 21,000 submissions. This is obviously a topic of great interest to many Canadians, and the government needs to take more time to fully hear the views of all parties;
- present clear and transparent economic modelling which demonstrates the various impacts of the 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.

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