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et
de Comptables professionnels agréés du Canada

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Ministère des Finances du Canada
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Acheminé par courriel à fin.consultation.fin@canada.ca

Objet : Propositions du 18 juillet 2017 : Section C du document de consultation *L'imposition des sociétés privées – propositions relatives au revenu passif*

Le Comité mixte sur la fiscalité de l'Association du Barreau canadien et de Comptables professionnels agréés du Canada (le « **Comité mixte** ») a le plaisir de vous soumettre son mémoire sur les propositions relatives au revenu passif contenues dans la section C du document de consultation *Planification fiscale au moyen de sociétés privées*, publié par le ministère des Finances le 18 juillet 2017 (les « **propositions relatives au revenu passif** »).

Ce mémoire est l'un des trois mémoires préparés par le Comité mixte, les deux autres portant sur les propositions législatives afférentes à la répartition du revenu et sur les propositions touchant la conversion du revenu en gains en capital.

Le Comité mixte réunit des intervenants des milieux juridique et fiscal canadiens; il est chargé de formuler, après analyse, des commentaires sur les lois fiscales à l'intention du gouvernement fédéral. Grâce à leur collaboration au sein du Comité mixte sur la fiscalité, CPA Canada et l'Association du Barreau canadien transmettent périodiquement, au ministère des Finances, depuis plus de 70 ans, des suggestions détaillées sur les aspects techniques des nouvelles dispositions fiscales. Le Comité suggère également des améliorations visant à simplifier et à faire évoluer les aspects techniques des lois fiscales. Nos recommandations reposent sur les expériences concrètes des membres des deux organismes professionnels dans l'exercice de leurs fonctions.

Compte tenu de la longueur du mémoire que nous soumettons, nous avons jugé utile de vous présenter un résumé des principales observations et recommandations détaillées qu'il contient. Nous tenons cependant à préciser qu'il ne s'agit que d'une version abrégée des observations et des recommandations qui font l'objet d'une analyse approfondie dans le mémoire.

Sommaire

Nos principales observations et les conclusions que nous en avons tirées peuvent être résumées dans les termes suivants :

1. Le Comité mixte recommande que les modifications législatives visant à donner suite aux propositions relatives au revenu passif ne soient pas adoptées sans qu'un groupe consultatif ou un groupe d'experts équivalent, composé de représentants de toutes les parties prenantes, n'ait au préalable étudié en profondeur les politiques fiscales sous-jacentes, les questions d'ordre conceptuel et les conséquences de ces mesures sur le plan concurrentiel et macroéconomique. Nous croyons que ce sujet est trop important pour que la démarche soit précipitée, en particulier si l'on considère, comme nous l'expliquons dans notre mémoire, que l'existence d'un problème n'est pas clairement démontrée.
2. De nombreux motifs importants étrangers à la fiscalité expliquent la poursuite d'activités commerciales par l'intermédiaire de sociétés. Cette forme d'organisation limite la responsabilité du propriétaire d'entreprise, ce qui l'incite à prendre des risques. Les sociétés facilitent également la mobilisation de capitaux. Une politique fiscale de longue date au Canada et dans la plupart des économies développées consiste à renforcer les incitatifs à la poursuite d'activités commerciales par le truchement de sociétés en assujettissant ces dernières à un taux d'imposition sensiblement moins élevé que ceux auxquels sont soumis les particuliers.
3. Le Comité mixte croit que les politiques fiscales en place depuis des années, justifiées et fondamentales, sur lesquelles reposent le régime fiscal canadien et les régimes fiscaux de la plupart des autres économies développées, tiennent compte des différences importantes qui existent entre le revenu d'emploi et le revenu d'entreprise. Le principe sur lequel est fondé le document de consultation semble aller à l'encontre de ces politiques établies de longue date, du fait qu'il s'appuie sur l'hypothèse implicite selon laquelle il faudrait placer le revenu d'entreprise et le revenu d'emploi au même rang par souci d'équité perçue. Le Comité mixte n'adhère pas à cette approche fondamentale, estimant que les différences entre le revenu d'emploi et le revenu d'entreprise sont légitimes.
4. À l'heure actuelle, le régime fiscal canadien est sous-intégré, si bien que le revenu d'entreprise gagné par l'intermédiaire d'une société ne présente pas d'avantage fiscal appréciable si ce revenu est imposé au taux général auquel sont assujetties les sociétés. En effet, compte tenu des taux d'imposition réels applicables aux dividendes auxquels sont assujettis les particuliers ainsi que des taux d'imposition réels du bénéfice des sociétés, les revenus de société qui sont assujettis au taux général d'imposition des sociétés et les revenus de placement des sociétés privées sont soumis à des taux d'imposition plus élevés que ceux qui s'appliqueraient à ces revenus s'ils étaient gagnés par un particulier, et ce, dans neuf provinces sur dix.
5. Bien que le placement de revenus admissibles au taux des petites entreprises soit, dans certaines provinces, soumis à un taux d'imposition inférieur, ce qui confère un avantage, l'importance de cet avantage est négligeable, et le régime dans son ensemble ne devrait pas être remanié simplement pour remédier à des anomalies qui surviennent lorsqu'un revenu de société est imposé au taux des petites entreprises, et encore moins si l'on considère que des modifications visant à restreindre grandement l'accès au taux des petites entreprises ont été adoptées récemment.
6. Comme le Canada, de nombreux pays appliquent de faibles taux d'imposition au revenu des sociétés par rapport aux taux marginaux supérieurs qu'ils appliquent aux particuliers; or, ces pays ne semblent pas pour autant souhaiter assujettir le revenu passif à des taux d'imposition élevés (comme le fait le Canada) ou adopter de façon générale une législation qui pénalise la conservation de fonds dans les sociétés aux fins de placement.
7. Si le gouvernement décide d'aller de l'avant, chacune des trois approches possibles relativement à la mise en œuvre des propositions sur le revenu passif exigera une réflexion beaucoup plus approfondie que ne le laisse supposer le document de consultation pour que l'objectif d'équité

soit atteint. Le Comité mixte n'est pas convaincu que les approches suggérées, dans leur forme actuelle, permettent d'atteindre ce but.

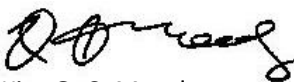
8. Les règles que contient actuellement la *Loi de l'impôt sur le revenu* du Canada quant à la distinction entre le revenu d'entreprise et le revenu de placement ont été conçues dans un tout autre but et ne permettront d'aucune façon la réalisation de l'objectif des propositions relativement au revenu passif. À notre avis, un régime entièrement nouveau serait nécessaire pour établir la distinction entre le revenu d'entreprise et le revenu passif. Le Comité mixte croit que la création d'un tel régime exigerait une étude approfondie visant à garantir que toute législation susceptible d'en résulter soit intégralement étayée par une politique sous-jacente reposant sur des fondements solides.
9. Si le gouvernement décide d'aller de l'avant, il lui faudra adopter des règles soigneusement élaborées et nuancées pour que les dispositions s'appliquent uniquement *a posteriori* et que tous les actifs accumulés dans les sociétés privées (de même que le revenu ultérieurement tiré de ces actifs) ne soient pas assujettis au nouveau régime. Si les règles transitoires portent préjudice aux propriétaires d'entreprises qui ont structuré leurs affaires dans l'hypothèse légitime où le régime existant serait maintenu indéfiniment, l'intégrité du régime fiscal canadien pourrait s'en trouver compromise.

Des membres du Comité mixte et d'autres experts en fiscalité ont pris part à la préparation de ce mémoire et ont contribué à sa rédaction, notamment :

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Nous vous remercions de l'attention que vous porterez à notre mémoire. Une fois que vous en aurez pris connaissance, nous serions ravis de pouvoir vous expliquer plus amplement notre point de vue lors d'une rencontre.

Veuillez agréer nos salutations distinguées,



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Joint Committee Submission on Passive Income Proposals described in Part C of *Tax Planning*
***Using Private Corporations* dated July 18, 2017**
(the “Consultation Paper”)

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1. Introduction

The Joint Committee has studied the proposals for taxing passive income earned by private corporations described in the Consultation Paper (the “**Proposals**”), and developed a series of observations and recommendations, which appear below.

The underlying premise of the Consultation Paper appears to be that equivalent amounts of employment income and business income should be subject to the same amount of income tax. This perspective appears to be rooted in the implicit assumption that income from these different sources should be computed and taxed in a similar manner. The Joint Committee believes that longstanding, well-founded, and fundamental tax policies currently reflected in the *Income Tax Act* (the “**Act**”) recognize the differences between these different sources of income. The premise of the Consultation Paper appears to be at odds with these longstanding policies.

This is one of the reasons why any legislative amendments similar to those discussed in the Consultation Paper should, in our respectful submission, not be adopted without serious study and due consideration by an advisory panel or comparable review by experts drawn from diverse backgrounds, as was done, for example, in the case of the Advisory Panel on Canada’s System of International Taxation, which reported to the Government in 2008. Moreover, as described in detail below, many of the assumptions underlying the Proposals in the Consultation Paper are, in our estimation, simply incorrect.

Furthermore, we question the statement in the Consultation Paper that lower corporate tax rates “were never intended to facilitate passive wealth accumulation”. It is reasonable to infer that previous governments were aware of the inevitable consequences of their actions, and that the enhanced accumulation of wealth in private corporations was either an intended consequence or an acceptable by-product of legislative changes, including changes to personal and corporate tax rates. It is also reasonable to infer that previous governments may have considered this aspect of the corporate tax rates as an additional incentive to business growth in Canada. Entrepreneurs considering the establishment of a business in Canada (rather than elsewhere) can be expected to take all relevant features of the tax system into account, including the fact that the rate gap (between “low” corporate business income tax rates and “high” personal tax rates) enables them to accumulate wealth in a private corporation. While it is of course open to the current Government to decide to change policy direction in this regard, we do not believe it is correct to assert that the proposed measures are simply addressing an unintended effect of the rate gap that is in the nature of a “loophole”.¹ Indeed, the concept of loophole seems to have no application in this context, and we suggest that characterization of the current system in this manner is unwarranted.

¹ For example, the Act includes a relatively detailed regime to curtail the use of shareholder loans as a means of extracting liquid assets from a corporation. There is no equivalent regime that affects retention of *bona fide* portfolio investments within a corporation. Indeed, the introduction of the regime that imposes additional refundable taxes on the investment income of CCPCs can be seen as an acknowledgement that CCPCs would be earning such investment income rather than distributing their retained earnings.

As we demonstrate in detail in this submission, we are also concerned that the Consultation Paper does not accurately represent either the extent of the perceived “problem”, or the probable effects of the “solution”. The analyses in the Consultation Paper presume that the current Canadian tax system results in “perfect integration”; that is, that there is no tax cost associated with earning income through a corporation. It is a well-known fact that this is not the case. In fact, any deferral benefits are contingent on overcoming the costs of under-integration. By ignoring this tax cost, the Consultation Paper overstates the deferral benefits available to corporate shareholders and, more importantly, greatly misstates the efficacy of the proposed changes. As is shown below, using the same assumptions about period of investment and rates of return as are used in the Consultation Paper, but using actual tax rates, the effect of the Proposals would be to impose a tax penalty to incorporation that in many cases is significantly greater than the tax benefit that the Proposals seek to eliminate. If history is a guide, there is no reason to expect perfect integration in the tax system, and the Consultation Paper’s failure to recognize and address this critical issue is a serious shortcoming.

One further introductory note: As the Department of Finance is well aware, the Proposals have generated considerable discussion comment from many commentators, some better informed than others. We would urge the Department of Finance to keep an open mind. We think it is important that everyone takes a broad view of the effect of these Proposals, and carefully considers the scope and probable effects of the changes that are proposed in the Consultation Paper. We strongly believe that no decision to address the concerns raised by the Consultation Paper should be taken before thorough, serious, public, and transparent consideration. The Proposals do not represent “tweaks” or changes to narrow technical provisions; rather, they would rewrite many of the basics of Canadian corporate taxation. Because any changes would affect essentially all small-to-medium and new businesses in Canada,² to proceed without great care and meaningful stakeholder engagement risks an outcome that creates a tax environment that is viewed as inhospitable from both a domestic and international perspective, raising the risk that the Proposals would inhibit economic activity and job creation.

In the discussion below, our comments are organized as follows:

- (a) We discuss the underlying reasons for incorporation of a business.
- (b) We comment on the existing regimes in the Act for calculating taxable income from the distinct sources of employment and business.

² We acknowledge that some commentators have expressed the view that the Proposals have no adverse impact on very small businesses. As explained below, we believe these assertions pre-suppose that small business owners will be sufficiently well advised and nimble to circumvent the otherwise negative effects of the Proposals by paying out all otherwise taxable income as salary or bonus. We believe this is not a realistic assumption. It also ignores the fact that commercial impediments may preclude the annual payout of all otherwise taxable income from a private corporation to its owners.

- (c) We address the need to recognize the reality of under-integration of corporate income in the existing system. While the Consultation Paper imagines a Canada organized as a unitary state with a perfectly integrated corporate tax system, we base our analysis on the real-world under-integrated system with which taxpayers in most provinces are currently familiar.
- (d) We comment on some of the key features that we believe should be taken into account in designing a coherent system for taxing certain types of so-called “passive” income of private corporations in a way that “equalizes” the economic outcomes of employees and business owners, including:
 - (i) how to define “excess” passive assets of a corporation;
 - (ii) how to distinguish “active” from “passive” income in a new regime where these distinctions have a much more significant consequence than ever before; and
 - (iii) how to design rules that treat inter-affiliate payments, dividends, capital gains, losses and partnership income properly.
- (e) We comment on the factors that should be taken into account in designing a coherent system that tracks the underlying capital that gives rise to each dollar of investment income in order to determine the extent, if any, to which the otherwise temporary taxes on a private corporation’s investment income would become permanent taxes.
- (f) We comment on the scope of any new regime, and whether it should apply to all private corporations, or only to Canadian-controlled private corporations (“CCPCs”).
- (g) We comment on the complex transitional rules that would need to be enacted to fulfill the stated objective that the new regime apply only “going forward”.

The Consultation Paper makes no attempt to flesh out the design features of a system that would convert currently temporary (refundable) taxes into permanent (non-refundable) taxes. The Consultation Paper suggests that existing rules for distinguishing “active” from “passive” income will suffice for purposes of this new regime. We disagree. These existing distinctions were designed to serve a much more limited purpose. If “passive” income derived from certain capital sources is to become subject to non-refundable corporate taxes of about 50%, we believe that the existing rules to distinguish active from passive income in the domestic context are both inadequate and inappropriate. Existing and previously proposed regimes for distinguishing active from passive income in other contexts are not difficult to find. Examples include the well-developed, but much more complex, system for taxing foreign affiliates and the proposed, but never-enacted, legislative proposals to replace the “offshore investment

fund” rules with the “foreign investment entity” or “**FIE**” rules. Each of these regimes addresses a contextually different fact pattern, so we do not suggest either such regime should be imported as such into the new active/passive regime for domestic income. Nonetheless, it is useful to make reference to the ways in which these other regimes have dealt with similar issues. This is one of the matters that could properly be studied by an Advisory Panel.

Throughout this submission, we comment on the inevitable complexities associated with a system which requires a determination of the capital from which every dollar of a private corporation’s passive income was derived. Yet this is what is required in order to achieve the “fairness” envisioned by the Consultation Paper. The Joint Committee believes that such a complex system, with its inevitable compliance burden, while essential to a coherent set of rules, would be a disproportionately complex way to address the perceived fairness issue.

The Consultation Paper raises a number of important questions that the Joint Committee does not have the resources or expertise to address in a comprehensive way. These include the gender implications, equity impacts and competitive and macroeconomic impacts of the Proposals. However, we believe these are critical considerations, and that they should be fully considered by individuals and organizations with expertise in those areas. As noted, an Advisory Panel would be an appropriate means of engaging with individuals with this expertise.

Recommendation:

For the reasons described in this submission, the Joint Committee recommends against the enactment of legislative amendments to give effect to the “passive income” proposals unless and until the underlying tax policies, design issues, and, perhaps most importantly, the likely adverse competitive and macroeconomic consequences of such measures have been thoroughly studied by an Advisory Panel or other similar body that includes representatives of all affected stakeholders.

We recommend that the terms of reference of such an Advisory Panel should, at a minimum, include those items specified in Appendix A.

2. Reasons for Incorporation

The Consultation Paper states that the number of CCPCs has increased from 1.2 million in 2001 to 1.8 million in 2014, that the number of corporations in professional services has tripled over the last 15 years, that the number of so-called “self-employed” individuals choosing to incorporate almost doubled between 2000 and 2016, and that CCPCs now account for more than twice the share of taxable active business income relative to GDP compared to approximately 15 years ago. We are not in a position to question these numbers, but we observe, as the Consultation Paper itself does, that there has been a significant shift towards a service economy in Canada and there are important commercial (non-tax) reasons that influence the decision to incorporate. It occurs to us that there may be many reasons for these increases in the number of CCPCs. On their own, these statistics are just as likely to be

indicative of an increasingly entrepreneurial economy as they are to be indicative of tax planning.³ Furthermore, to the extent tax planning does account for some portion of the increased number of CCPCs, this phenomenon would seem to be the foreseeable result of government policies previously enacted.

As in other comparable jurisdictions, incorporation is the “normal” form of business organization in Canada. The Consultation Paper appears to be based on the assumption that businesses incorporate solely for tax reasons. Our perspective is that this is too narrow a view. Based on our experience, businesses incorporate for three main reasons:

1. limited liability;
2. ability to raise capital; and
3. potential income tax advantages.

a) Limited liability

One of the most significant reasons to incorporate is to limit liability. This may seem obvious to some but the importance of this point cannot be overstated in this context.

Under Canadian corporate law, the only way a business owner can reliably limit his/her liability is by incorporating. It is true that limited partners of a limited partnership also may enjoy a form of limited liability, but limited partners who are entrepreneurs or other individuals who are active in the management and control of the business do not enjoy limited liability.⁴ Unlike the situation with a corporation, in which it is highly unusual for courts to “pierce the corporate veil”, in the case of a limited partnership, there is often intolerable uncertainty as to whether a limited partner will be considered sufficiently inactive as to enjoy limited liability. In reality, therefore, limited liability can be reliably obtained only by incorporating.

By limiting the owner’s liability to the equity capital invested in the corporation, and by only exceptionally piercing the corporate veil, Canadian corporate law tends to facilitate the business-development process by limiting exposure to risk. This is especially important in some businesses where unknown and potentially catastrophic contingent liabilities may arise from ordinary business operations. For example, a business engaged in software development could face massive product liability claims if the software malfunctions. A business involving ownership or development of real or resource property is exposed to potentially significant claims for environmental remediation. Even a furniture manufacturer or plumber, or, for that

³ With respect to the number of corporations engaged in professional services, we expect that at least some of the increase reflects regulatory and legislative changes that have permitted professions that could not previously be carried on by a corporation to be carried on by a corporation.

⁴ It is true that some limited partnership statutes, notably that enacted by Manitoba, provide relatively “better” liability protection than others. However, no partnership statute in Canada provides the same kind of limited liability to active business owners as is provided through use of a corporation.

matter, any other person engaged in a business is exposed to potential claims. It is only by incorporating that the entrepreneur's potential exposure to these liabilities can be capped at a known amount. Because the corporate form tends to limit downside exposure of the unsuccessful venture, while allowing the successful entrepreneur to reap all of the upside, risk-taking tends to be encouraged. The ability to carry on a business without putting all of the entrepreneur's assets at risk can be a critical component in evaluating whether a business venture should be undertaken, continued or expanded. This also enhances economic efficiency by allowing the risk exposures of equivalent ventures to be less affected by any differentials in the amounts of the personal assets of their stakeholders.

The corporate form also allows operations of particularly risky operations to be "ring-fenced", so that assets of other operations can be insulated from claims against that risky operation. For this reason, in the real estate industry, and in regulated businesses, it is common to have separate corporations for each activity.

The current Canadian tax system already contains a disincentive to optimal segregation of business operations because it lacks corporate consolidation or group relief. This highly unusual feature of Canada's tax system tends to diminish entrepreneurs' appetite to take risk by imposing a potential tax penalty to having multiple corporations, each of which must file its own tax return, and which may give rise to corporate tax liabilities even where the overall group is unprofitable. While "self-help" methods are available to mitigate this inefficiency, resort to those methods is costly. The discussion in the Consultation Paper makes no reference to this imperfection in the Canadian tax system, and indeed seems to be premised on an extremely simple corporate structure involving a single corporation.

b) Raising Capital

While some businesses might otherwise be carried on as sole proprietorships or partnerships, even though they would lack limited liability, there is a further commercial reason for incorporating. New and growing businesses require capital. While capital can be provided informally by the entrepreneur and his/her friends and family,⁵ many businesses carried on by ambitious entrepreneurs will need to tap other sources of capital. Particularly for start-up businesses, access to bank financing at reasonable rates may be difficult or impossible to obtain. Alternative sources of financing may involve issuances of subordinated debentures, preferred or common equity, warrants, options or other securities to investors. Alternative sources of financing may include convertible debt, either because it lowers the interest cost to the business or because the lender insists on the right to share in the equity "upside". Convertible debt of a corporation is well understood and may be converted on a tax-deferred basis. Convertible debt of a limited partnership while perhaps theoretically possible, would possibly raise commercial concerns about the status of the investor as creditor or partner. Moreover, even if it could be issued, as it cannot be converted on a tax-deferred basis, it would not be an attractive form of financing.

⁵ For a discussion of some issues arising with respect to intra-family financing, please refer to the Joint Committee's TOSI submission dated October 2, 2017.

The raising of capital by issuance of these various types of securities is facilitated by incorporation. Debentures, common or preferred shares, warrants, options and other securities can readily be issued by corporations, and are well understood. While limited partnerships could theoretically be used, they do not provide limited liability to the entrepreneur, and moreover, even for passive investors, they do not provide the optimal type of limited liability. Indeed, in the early 2000s, conservative investors such as large pension funds were unwilling to invest in income trusts because of liability concerns until the relevant legislation was amended to provide limited liability comparable to that available to shareholders of corporations. If the source of capital is non-residents, equity of a limited partnership is not a desirable investment. From the entrepreneur's perspective the partnership would lose its status as a Canadian partnership adding compliance burden and reducing flexibility. From the investor's perspective, as a limited partner in a partnership carrying on business in Canada, it would have an obligation to file a Canadian income tax return, something generally not required of an owner of debt or equity of a corporation.⁶

Finally, particularly in the start-up phase, it may be necessary to offer employees equity participation in the business, to entice them to join the business or to provide additional compensation in recognition of the sacrifice they may make at the outset (e.g., by taking a somewhat lower than market salary, by working extra hours, etc.). The favourable rules in the Act for employee stock options only apply to options to acquire shares⁷ of a corporation, and more favourable rules are available for options on shares of CCPCs.

Overall, investors understand and are most familiar with the corporate form. The corporate form enables entrepreneurs to raise capital (including human capital) more efficiently than they could without a corporation.

c) Income Tax Benefits

As in most comparable jurisdictions, the corporate tax rate under the Act is much lower than the maximum marginal personal rate. By imposing a lower tax rate on business income generated inside a corporation, Canada's tax system tends to reinforce the policy of encouraging risk-taking. The entrepreneur is therefore further incentivized to incorporate, as the after-tax corporate profits derived from business activities conducted by the corporation are higher than if those activities had been conducted in a sole proprietorship or partnership. A lower corporate tax rate is of benefit to an entrepreneur not only because it provides the entrepreneur with more capital to reinvest in the business, but, at least as importantly, because it permits him/her to realize more after-tax profits which can be set aside for possible investment in other ventures or for future consumption. Moreover, all businesses experience

⁶ If the equity is taxable Canadian property an obligation to file a tax return may arise on disposition of the equity.

⁷ There are also rules applicable to units of mutual fund trusts but businesses typically would not be carried on through a mutual fund trust. In addition to the requirement to have broadly held equity, none of the benefits available to CCPCs (e.g., SBD, investment tax credits, more favourable stock option rules, etc.) are available to mutual fund trusts.

good times and bad. Prudence demands having after-tax corporate profits available and held in contingency reserve to keep the business afloat when business conditions deteriorate. The amount that ought to be held in contingency reserve is not a simple question, and undoubtedly varies from business to business as a matter of sound business judgement.

Canada is not alone. As noted above, it is very common internationally for the corporate tax rate to be substantially less than the top personal rate. The table below summarizes the top corporate rates and top personal income tax rates in sixteen other developed countries, and in all except the United States⁸ and New Zealand, the rate differential exceeds 15%. In several, the rate differential exceeds 20%.

Country	Corporate Tax Rate⁹	Highest Marginal Tax Rate¹⁰
Australia	30%	49%
Belgium	33.9%	53.3%
Denmark	22%	55.8%
France	34.43%	54%
Germany	30.18%	47.5%
Ireland	12.5%	48%
Israel	24%	50%
Italy	27.81%	48.8
Japan	29.97%	55.7%
Luxembourg	27.08%	43.6%
Netherlands	25%	52%
New Zealand	28%	33%
Sweden	22%	57.1%
Switzerland	21.15%	41.7%
United Kingdom	19%	45%
United States	38.91%	46.3%

Of course, the corporate tax is not the end of the story. If and when after-tax corporate profits are distributed by the corporation to the shareholders, a second level of tax is imposed. While Canada's corporate tax system is, in theory, supposed to reflect "integration" – i.e., neutrality between (i) the personal tax imposed on business income earned directly, and (ii) the aggregate corporate and personal taxes imposed on business income earned by a corporation and then distributed by way of dividend – this is unfortunately not the case in Canada. As discussed

⁸ In the United States, private businesses are invariably carried on through corporate entities which are fiscally transparent, such as S-corporations and limited liability companies, and therefore the corporate tax rate is of little practical consequence for these businesses.

⁹ http://stats.oecd.org/index.aspx?DataSetCode=TABLE_I14 Table I.7.

¹⁰ http://stats.oecd.org/index.aspx?DataSetCode=TABLE_I14 Table II.1.

below, an entrepreneur based in Ontario or Québec, for example, generally faces 2-3% more overall income tax if the income is earned through a corporation.¹¹

This “under-integration” tends to discourage incorporation, but, under current rules, this disadvantage is mitigated or offset by the advantages that can be obtained by deferring the distribution of corporate profits. If the advantages of deferral are to be eliminated, as suggested in the Consultation Paper, then, steps need to be taken to eliminate the disadvantages of under-integration. Surely, the Canadian tax system should not frustrate the underlying public policies reflected by the incorporation regime by making the tax on business income earned by a corporation and set aside for future consumption higher than the tax that would have been paid had the income been earned by the entrepreneur directly. Yet that is exactly what would result from a change such as that suggested in the Consultation Paper. If “fairness” is rate parity, then it ought to flow both ways. Under-integration is a result of the combined effect of federal and provincial taxes, but it ought to be recognized and addressed, rather than simply assumed away.

Unlike many other countries, Canada’s corporate tax system imposes refundable taxes on “investment” income earned by CCPCs. The theory underlying these refundable taxes is that the investment income earned by a CCPC “should” be taxed at rates approximating those that the ultimate individual shareholders would face on that investment income earned by them directly. This unusual¹² feature of Canada’s system thereby tends directionally to undermine the incentive effects of low corporate tax rates. Mobile entrepreneurs can be expected to take this and other features of the corporate tax system into account when deciding where to locate.

When corporate tax rates are less than personal tax rates, and the entrepreneur wishes to set aside profits for possible investment or future consumption, there is obviously more cash available in the corporation than there would have been had the income been earned personally and been subject to higher personal tax rates. As noted above, this foreseeable consequence of the existing system can hardly be considered a “loophole”. Rather, it is the entirely predictable effect of a system – which is observed in Canada and many other countries – in which the corporate tax rate is lower than the personal tax rate.

We believe that the most important feature of Canada’s current system for taxing private companies is the fact that the general corporate tax rate (26-27% in most provinces) is much lower than top personal rates (generally over 50%). Especially for ambitious entrepreneurs in start-up mode, the long-term business plan is to become very profitable. Of course, many businesses fail. But the essence of the ambitious entrepreneur is that he/she strives to succeed. In our experience, that ambition is not limited to earning profits corresponding to the

¹¹ This is based on the general corporate tax rate. We realize a corporation may sometimes pay salaries and bonuses to individual business owners who perform services for the business, but this is not always feasible particularly where there are multiple shareholders, so in reality under-integration is a major issue.

¹² See the paper authored by Michael Kandev and Nat Boidman published in *Tax Notes International*, September 4, 2017.

annual business limit for the so-called “small business deduction” (“SBD”). The Government’s focus in the Consultation Paper seems to be on the SBD. If anomalies are perceived with respect to the SBD, then those anomalies should be corrected. But the basic system should not be upended.

While access to “low” (26-27%) corporate tax rates does reinforce the incentive to incorporate, there can be a significant tax downside to incorporating. As noted, many businesses fail. Failed businesses tend to produce losses. However, if the failed business was carried on by a corporation, those losses will be “trapped” in the corporation, rather than being available to be deducted against income of the individual shareholders from other sources. At best, the owner of the corporation may be able to claim a capital loss on disposition of worthless shares. In limited circumstances, the Act permits the shareholder to treat one-half of the actual loss as an ordinary loss by claiming it as an “allowable business investment loss” or “**ABIL**”. The ABIL rules tend to encourage incorporation of business activities, further reinforcing the general public policy favouring incorporation of businesses.

There are other tax benefits of incorporation as well. Most notably, except for farming and fishing businesses, the lifetime capital gains exemption (“**LCGE**”) is available only where shares of a qualifying small business corporation (“**QSBC**”) are disposed of at a gain.¹³ In the 1991 Federal Budget, the following was stated as one of the rationales for the LCGE:

In recognition of the contribution of the small business sector to job creation and innovation, the federal government provides an enhanced lifetime capital gains exemption of \$500,000 for gains realized by individuals on the disposition of qualified small business corporation shares. The enhanced exemption encourages investment, risk-taking and broader individual participation in the equity of Canadian-controlled private corporations, which face more difficulty in attracting capital than larger, public corporations. (Emphasis added.)

This clear statement further underlines the deliberate public policy favouring risk-taking through incorporation.

The Consultation Paper does not consider this longstanding tenet of public policy in Canada. No mention is made of the deliberate policy choices, both in tax law, and other branches of law, to encourage risk-taking. Rather, it is implied that incorporation is merely a feature of tax planning that somehow confers an inappropriate advantage on business owners, as compared to employees. In our respectful submission, this perspective is too narrow, and does not accord with longstanding trends in public policy in Canada, and in other jurisdictions.

¹³ We acknowledge that it is sometimes possible to incorporate immediately before a sale, relying on section 54.2, to obtain the benefit of the LCGE. However, this is not always feasible, and even where it is, there can be additional costs (e.g., costs, taxes and fees associated with transferring assets, need to obtain third party consents, etc.). More practically, many entrepreneurs will simply choose to incorporate at the outset with knowledge they can access the LCGE if they qualify. In other words, this is a clear example of the Act essentially forcing incorporation.

3. Distinctions Between Employment Income and Income from Business

The underlying premise of the Consultation Paper appears to be that equivalent amounts of employment income and business income should be subject to the same amount of income tax. This view appears to reflect an unarticulated assumption that business income and employment income “should” be computed and taxed in a similar way. That view does not take into account key features of Canadian tax law and policy.

The Act has always recognized the distinction between income from employment and income from a business, whether the business is carried on by an individual, a corporation or a partnership. As noted above, particular provisions in the Act have been enacted as a direct consequence of the recognition that the risks of carrying on a business are significantly greater than the risk profile assumed by an employee.

At the most basic level, employees are taxed on a cash basis, while business income is taxed on an accrual basis. Deductions available to employees in respect of employment income are very limited. This recognizes the fact that business owners bear the cost of capital and other costs of operating a business, with a view to (but no assurance of) a profit. Indeed, businesses can give rise to profits or losses. Employment gives rise to income, but, in general does not result in losses.

In computing income from a business, a broad range of deductions are available, including deductions in respect of capital outlays (e.g., interest and capital cost allowances).¹⁴ Business income can be earned through a corporation, while employment income cannot.¹⁵

Although retention of business income in a corporation provides an opportunity to defer the second level of tax (which deferral, as noted, is needed in order to offset the disadvantages of under-integration), the Act expressly permits employment income to be deferred under specific arrangements. These include registered pension plans (“**RPPs**”), RSUs, DSUs, and plans contemplated by the exceptions to the “salary deferral arrangement” rules.¹⁶ In some cases salaries can be averaged over a period of time (under a sabbatical plan or leave of absence plan).¹⁷ Employees may be granted stock options as part of their compensation package; the tax rules expressly permit employees (but not business owners) to defer the recognition of a

¹⁴ There are limitations on business expenses as well: general limitations, such as the reasonable limitation in section 67 and for the purpose of earning income limitation in paragraph 18(1)(a), as well as express limitations, such as the restriction in section 67.1 relating to meals and entertainment.

¹⁵ While the term “self-employed” is often used to describe individuals carrying on a business, they are nonetheless not employees and are carrying on a business. The “personal services corporation” rules preclude an employee from incorporating to provide employment services. These provisions of the Act recognize the fundamental difference between employment income and business income.

¹⁶ These include deferred bonus plans, employee profit sharing plans, deferred bonus plans and plans described in Regulation 6801(d).

¹⁷ See Regulations 6801(a),(b) and (c).

taxable benefit upon grant of an option, and the income realized upon exercise of an option by an employee who deals at arm's length with the employer will, in most cases, be subject to taxation at capital gains rates.

Many of the benefits available to employees are not available to so-called "self-employed" individuals. While such individuals may qualify for Canada Pension Plan benefits, they effectively bear both the employer and employee portion of premiums, essentially double the amount borne by a typical employee. Although they may qualify for some employment insurance benefits, they are less generous than those available for employees.¹⁸ Although such individuals may make contributions to a registered retirement savings plan ("RRSP") or tax-free savings account ("TFSA"), while the business is in the early stages, the individual's "earned income" will frequently not be sufficient to permit maximum, or even any, contributions to those plans because the entrepreneur will be retaining cash in the business to meet potential (and unknown) cash needs of the business, or to satisfy lenders who are unwilling to allow cash to leave the business. Even when the business reaches profitability, it may be economically rational for the individual to reinvest in the business rather than having the corporation increase salary to the owner/manager to enable him/her to contribute to an RRSP or TFSA. This will frequently leave so-called "self-employed" individuals with significant "catching up" to do relative to their "neighbour" who is an employee and a member of an RPP and/or has been able to contribute to an RRSP and/or TFSA since gaining full-time employment. In reliance on the reasonable expectation that the current system would be maintained, such individuals may have caused their private corporations to pay them only modest salaries or bonuses, and therefore may lack the "earned income" necessary to give rise to a carry forward of unused RRSP contribution room. Finally, making a contribution to a plan such as an RRSP may make that capital unavailable for business use in the future due to the restrictions on investments that deferred income plans such as an RRSP can hold.

4. Actual Tax Advantages from Investing in a Private Corporation

The Proposals are premised on the understanding that individuals use private corporations as a savings vehicle in order to gain a tax advantage. The Consultation Paper states that the current tax system *"leads to unfair tax results, whereby a corporate owner may frequently prefer to retain business income for passive investment purposes, within his or her corporation, rather than to pay it out and invest directly as an individual."* The numerical Tables included in the Consultation Paper are intended to illustrate the tax advantages of saving within a corporation under the current system.

In reality, and as mentioned above, businesses incorporate for many reasons, some of them completely unrelated to tax advantages. Furthermore, the actual tax advantages of investing in a private corporation are not as illustrated in the Consultation Paper. In fact, there can be a distinct tax disadvantage to investing within a private corporation, due to the significant and persistent under-integration currently embedded within the Canadian tax system.

¹⁸ <https://www.canada.ca/en/services/benefits/ei/ei-self-employed-workers.html>

In this section of our submission we illustrate, using actual tax rates, rather than the theoretical (but not real) rates used in the Consultation Paper, that the current system already imposes higher taxes on business income and investment income earned through a corporation than would apply were the income earned by an individual subject to the top marginal tax rate in most provinces.

In this regard, we have replicated some of the Charts and the examples in the Consultation Paper using actual tax rates and assuming the income is taxed at the general corporate tax rate rather than the SBD rate. As is illustrated, any advantage that currently exists is available only where the SBD applies, and even then, the advantage is not, in our view, material in most circumstances.

a) ***Under-integration***

The Consultation Paper describes the concept of tax integration, which is aimed at “*making sure that an individual is indifferent between earning income through a corporation or directly.*” However, tax integration in Canada does not work in the way it “should” in theory. In fact, in almost every province there is significant under-integration, and individuals may actually be better off earning income and investing directly than through a private corporation. However, the need for limited liability and to access capital forces many entrepreneurs to incorporate despite the disadvantages.

Active business income earned in a corporation, and distributed to individual shareholders as dividends, is currently subject to under-integration at the following rates:¹⁹

Province	Income Taxed at Small Business Rate	Income Taxed at General Rate
British Columbia	(0.63%)	(1.66%)
Alberta	(0.63%)	(2.24%)
Saskatchewan	0.58%	(1.18%)
Manitoba	(1.04%)	(4.26%)
Ontario	(0.02%)	(1.97%)
Quebec	(0.92%)	(2.69%)
New Brunswick	(0.21%)	0.51%
Nova Scotia	(0.13%)	(5.69%)
Prince Edward Island	(0.92%)	(3.24%)
Newfoundland and Labrador	0.07%	(8.53%)

¹⁹ All numbers in this submission reflect the highest marginal Canadian income tax rates for 2017.

Investment income²⁰ (including taxable capital gains), which is subject to high corporate tax rates as earned, is also subject to significant under-integration as follows:

Province	Investment Income
British Columbia	(4.47%)
Alberta	(5.03%)
Saskatchewan	(3.64%)
Manitoba	(6.19%)
Ontario	(2.44%)
Quebec	(1.65%)
New Brunswick	(4.78%)
Nova Scotia	(5.70%)
Prince Edward Island	(5.97%)
Newfoundland and Labrador	(5.29%)

Accordingly, active business income and investment income earned in a private corporation, and paid out to the individual shareholders as dividends on a current basis, is almost always more highly taxed when compared to an employed individual earning the same quantum and type of income.²¹ For example, an individual resident in Newfoundland who owns a private corporation that earns \$100,000 of active business income in a private corporation (taxed at the general corporate tax rate) and who causes it to distribute the after-tax funds to himself/herself as a dividend has almost \$8,530 less cash than if he/she had earned the \$100,000 directly. This is counter to the principle of fairness espoused as the fundamental premise of the Proposals, which is that an individual should be “*indifferent between earning income through a corporation or directly.*”

b) ***Advantages of Deferral***

As described above, current Canadian tax rates almost always disadvantage those who carry on business and/or invest within a private corporation unless deferral is available. Individuals who operate a small business in a private corporation for valid commercial reasons are penalized if they withdraw the after-tax funds as a dividend on a current basis. The Consultation Paper indicates that individuals investing through a private corporation are advantaged though the ability to defer dividend distributions, stating that “*while the corporation’s owner will have to*

²⁰ Portfolio dividends subject to Part IV tax are integrated.

²¹ Bonusing down the corporate income in order to avoid under-integration may be subject payroll taxes such as the Ontario, employer health tax, which applies if payroll of the corporation exceeds \$450,000. Note that this threshold applies to total payroll, so a private corporation with, say 10 employees/business owners earning \$50,000 each is subject to the payroll tax. And, of course, it may not be feasible to pay out the after-tax income as additional salary or dividend currently where the funds are needed to expand or maintain the business or where, despite taxable income, there is not sufficient cash to do so. If tax rates rise between the year in which the income is earned by the corporation and the year in which it is paid out to the individual owner(s) as dividends, greater under-integration may result.

pay personal taxes upon dividend distribution, the strategy still provides the owner with a significant tax deferral advantage derived from the fact that he or she is the owner of an incorporated business – an advantage not available to most other Canadians.”

In fact, funds are often retained in a corporation for prudent business reasons, including saving for future expansion, hedging against business decline, and managing cyclical markets and uneven cash flows. Lenders or other creditors may simply require funds to remain in the corporation for the corporation to maintain its credit standing. Business owners may retain funds for possible extraordinary expenses or for possible future acquisitions. However, beyond those reasons for retaining the funds in the corporation, it is necessary to retain funds in the corporation and invest a greater after-tax amount in order to try to counter all or at least a part of the under-integration disadvantage.

In fact, the ability to invest after-tax active business income in a corporation, and defer the individual level of tax until a future dividend is paid, often will not fully offset the disadvantage of under-integration. For example, as illustrated below, if an individual resident in Ontario, and otherwise subject to the highest marginal tax rate, incorporates his/her business and, in that private corporation, earns \$100,000 of active business income, taxed at the general corporate tax rate,²² annually, and invests the after-tax amount at 3% over a 10-year period, that individual is actually worse off at the end of year 10 than if she had earned and invested the annual \$100,000 personally.

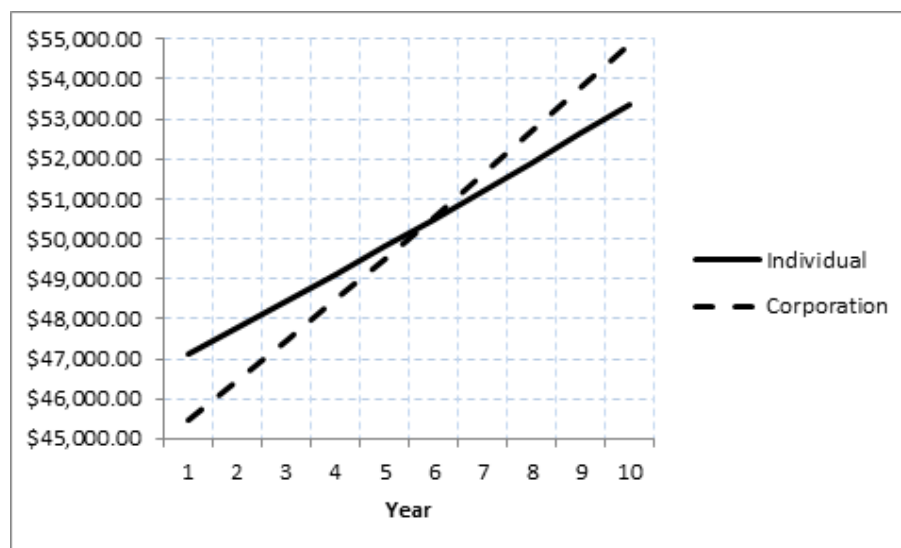
	Individual (\$)	Corporation (\$)
Annual Net Income	100,000	100,000
Federal/provincial personal or corporate tax	(53,530)	(26,500)
Starting Portfolio	46,470	73,500
Return on Investment in Year 1		
Interest at 3%	1394	2205
Non-refundable personal or corporate taxes	(746)	(430)
Refundable Taxes (RDTOH)		(676)
After-tax investment income	648	1099
Portfolio value after 10 years	501,864	798,224
Refund of refundable tax (RDTOH)		38,914
Personal income tax on eligible dividends		(283,248)
Personal income tax on ineligible dividends		(53,064)
Net worth	501,864	500,827

²² The general corporate rate applies to “large” CCPCs (having taxable capital above \$15 million). It may also apply to smaller CCPCs that are required to “share” the SBD. We believe the general corporate rate is the appropriate starting point for the analysis, because aspiring entrepreneurs can be expected to take into account all features of the Canadian tax system that might apply if their venture proves successful. Furthermore, the separate analysis of the general and small business rates helps illustrate the extent to which the source of the “problem” perceived by the Government may in fact be the SBD itself, rather than a more systemic problem.

A similar result is obtained in 8 of the 10 provinces, where the comparative net worth of the individual after 10 years would be as follows:

Province	Individual (\$)	Corporation (\$)	% Benefit (on \$1,000,000)
British Columbia	570,325	567,578	(0.28)
Alberta	566,771	556,720	(1.01)
Saskatchewan	569,732	572,352	0.26
Manitoba	538,460	508,086	(3.04)
Ontario	501,864	500,827	(0.10)
Quebec	504,424	496,861	(0.76)
New Brunswick	504,540	524,621	2.01
Nova Scotia	496,400	452,524	(4.39)
Prince Edward Island	527,079	507,380	(1.97)
Newfoundland and Labrador	527,899	454,224	(7.37)

If the individual earns \$100,000 only in year one and invests it at 3% for the next 10 years, the corporate deferral advantage more quickly offsets the under-integration disadvantage. For example, in Ontario, an individual is only better off earning income in his/her corporation (taxed at the general corporate tax rate) and investing at a 3% return at that level, if he/she retains the funds in the corporation for at least 6 years. At the end of year 10, the individual who earned the income directly would have a net worth of \$53,370 and the individual who earned through a private corporation would have a net worth of \$54,885. The comparative net worth graph would look as follows:



Even at the end of the 10 years, the individual is only advantaged by an amount equal to 1.515% of his/her initial \$100,000 of income. In other provinces, it takes much longer to realize

a net benefit from the deferral advantage. For example, in Manitoba an individual earning \$100,000 in year one in a corporation (taxed at the general corporate tax rate) and investing the after-tax funds at 3% is only better off after close to 20 years. In Nova Scotia, the individual needs an investment period of almost 25 years, and in Newfoundland and Labrador an investment period of more than 25 years is needed.

The comparative net worth in each province (assuming active business income of \$100,000 in year one only, taxed at the general corporate rate and invested at 3%) at the end of the 10-year period would be as follows:

Province	Individual (\$)	Current System (at general rate) (\$)	% Benefit (on \$100,000)
British Columbia	61,110	62,015	0.905
Alberta	60,706	60,755	0.049
Saskatchewan	61,043	62,536	1.493
Manitoba	57,495	55,506	(1.989)
Ontario	53,370	54,885	1.515
Quebec	53,658	54,575	0.917
New Brunswick	53,671	56,858	3.187
Nova Scotia	52,757	49,344	(3.413)
Prince Edward Island	56,209	55,069	(1.140)
Newfoundland and Labrador	56,302	49,902	(6.400)

The assumed numbers and rates used in the Consultation Paper (Table 10) show a benefit to incorporation of 2.92%¹¹ at the end of the 10-year period, which is higher than the actual benefit realized in 9 out of 10 provinces. In fact, in 4 of the 10 provinces, an incorporated individual remains economically worse off at the end of the 10-year investment period.

The results will vary depending on the assumed investment return, investment period and future individual and corporate tax rates. With a high enough rate of return and long enough investment period, an individual may be better off with savings accumulating in a corporation. However, certain events, such as death or personal financial distress, may force an individual to extract funds from his/her private corporation prematurely, well before the deferral advantage has outweighed the under-integration disadvantage. In addition, if individual tax rates increase in the future, the incorporated individual is again disadvantaged. Accordingly, in the real world, it is simply not the case that earning active business income (taxed at the general corporate rate) and investing the after-tax amount within a private corporation will necessarily be financially advantageous (when compared to earning and investing that income directly).

A greater deferral advantage is available where the active business income earned in a private corporation is subject to the SBD. As noted above, while active business income subject to the SBD also is under-integrated in most provinces, the under-integration is less significant than it is

¹¹ [After correcting the error re: calculation of GRIP/eligible dividends.](#)

for active business income taxed at the general corporate tax rate. The following table illustrates the actual benefit in the real world taking into account the more pronounced advantages for SBD income. The comparative net worth of an individual earning \$100,000 of active business income annually for a 10-year period, taxed at the SBD rate, and investing the after-tax amount at a 3% annual rate over that 10-year period, would be as follows:

Province	Individual (\$)	Corporation (\$)	% Benefit (on \$1,000,000)
British Columbia	570,325	588,967	1.86
Alberta	566,771	584,624	1.79
Saskatchewan	569,732	601,743	3.20
Manitoba	538,460	552,662	1.42
Ontario	501,864	529,561	2.77
Quebec	504,424	521,054	1.66
New Brunswick	504,540	527,398	2.29
Nova Scotia	496,400	518,643	2.22
Prince Edward Island	527,079	539,442	1.24
Newfoundland and Labrador	527,899	552,304	2.44

Although these numbers do illustrate an advantage to investing within the private corporation, the advantage varies by province. For example, there is a 2.77% tax benefit in Ontario on the \$1,000,000 of active business earnings at the end of the 10-year period. The largest percentage advantage at the end of the 10-year period is realized in Saskatchewan, at 3.2% on the \$1,000,000 of active business earnings.

The comparative net worth of an individual earning \$100,000 in year one only, taxed at the SBD rate, and investing the after-tax amount at 3% for a 10-year period, would be as follows:

Province	Individual (\$)	Corporation (\$) (at small business rate)	% Benefit (on \$100,000)
British Columbia	61,110	65,113	4.00
Alberta	60,706	64,555	3.85
Saskatchewan	61,043	66,485	5.44
Manitoba	57,495	61,025	3.53
Ontario	53,370	58,510	5.14
Quebec	53,658	57,549	3.89
New Brunswick	53,671	58,095	4.42
Nova Scotia	52,757	56,993	4.24
Prince Edward Island	56,209	59,279	3.07
Newfoundland and Labrador	56,302	60,766	4.46

Again, the greatest advantage would be realized in Saskatchewan, with a net worth 5.44% higher at the end of the 10-year period for an individual who incorporated his/her business and invested in the corporation.

c) *Effect of the Proposals*

The “*Alternative Approach*” described in the Proposals suggests eliminating the refund of taxes in respect of investment income earned by a private corporation which was sourced from the investment of after-tax active business earnings (whether taxed at the SBD rate or the general corporate tax rate). In general terms, the characterization and tax treatment of passive income from an investment would depend on the source of the capital that was used to fund the investment. In particular:

- investment income funded from the investment of active business income taxed at the SBD rate would not be entitled to refundable taxes or CDA, and would be paid out as ineligible dividends;
- investment income funded from the investment of active business income taxed at the general corporate tax rate would not be entitled to refundable taxes or CDA, but would be paid out as eligible dividends; and
- investment income funded from the investment of shareholder contributions (and presumably, though conspicuously not mentioned in the Consultation Paper, other “tax-paid” sources such as borrowings, the proceeds of issuance of bonds, debentures, shares, warrants, options or other securities) would be either paid out tax-free to shareholders or subject to refundable taxes and paid out as ineligible dividends (i.e. same as the current tax treatment).

The design of a system that achieves these objectives is likely to be highly complicated. Rules would be required to determine the capital from which every dollar of investment income is ultimately sourced (either through a tracing method or a proxy method, such as “apportionment, as suggested in the Consultation Paper). A series of “pools” or “surplus” accounts will need to be defined and tracked so that the corporation is able to determine precisely which investment income is to be subject to the new non-refundable regime. Income from assets derived by a corporation from the issuance of securities or from foreign sources generally should not be subject to the new regime, since these assets did not benefit from “low” corporate tax rates. The policy dilemma is clear – in order to design a fair and coherent system, the rules will need to be nuanced and complex; yet this very complexity is apt to create a compliance burden for every single private corporation that we are concerned may be overwhelming for many of them, especially for smaller private corporations.

Related to this, and as discussed below, the transitional rules will need to specify how the capital accumulated by the corporation up to the coming-into-force date is to be determined, and each dollar of investment income that is derived from that capital (including reinvested income or proceeds of disposition) will need to be determined so that the Government’s stated objective of applying the new regime only “going forward” can be achieved.

Special rules will need to be designed to deal with rollovers, wind-ups, amalgamations and divisive reorganizations. With this complexity, there will no doubt be a need for anti-avoidance rules to ensure the integrity of the new system. We anticipate that the development of a fair and coherent set of rules to implement this novel plan will be a major undertaking.

As an alternative to the Apportionment Method, the Consultation Paper suggests that taxpayers may be subject to a default tax treatment, whereby all income would be considered to be sourced from active business income taxed at the SBD rate (the “**default method**”). Taxpayers may be able to elect out of the default method (the “**elective method**”), whereby all income would be considered to be sourced from active business income taxed at the general corporate tax rate. However, under the elective method, the SBD would not be available to the electing corporation. Finally, where a corporation earns only (or substantially all) investment income (using funds taxed at the personal rate), the current tax rules would continue to apply (refundable taxes and ineligible dividends).²³

Set out in the chart below are the nominal tax rates on investment income that would result across all provinces. These rates are a result of the combination of under-integration and the denial of refundable taxes. Effectively, these rates appear to be designed to tax away the “gap” between personal and corporate rates, but do not at the same time fix the under-integration problem.

²³ We have assumed that the investment company election would be available to any corporation that chooses it. In other words, a corporation with little business income may choose to treat that income as passive and subject to refundable taxes, notwithstanding the higher tax at the outset on that business income, simply because the compliance burden or cost associated with the other methods is not warranted in the circumstances.

Province	Combined Tax Rate on Distributed Investment Income Under the Alternative Approach (%)		
	Default Method	Elective Method	PIC Election
British Columbia	70.28	65.42	52.17
Alberta	71.04	66.31	53.03
Saskatchewan	69.91	65.28	51.39
Manitoba	73.23	69.31	56.59
Ontario	72.24	69.77	55.97
Quebec	72.18	70.2	54.96
New Brunswick	74.56	68.53	58.08
Nova Scotia	75.96	73.52	59.7
Prince Edward Island	74.56	70.18	57.34
Newfoundland and Labrador	73.88	73.41	56.59

The Consultation Paper states that under the Alternative Approach “*the passive investment of an individual investing in his or her small incorporated business would be **equal** to that of a salaried individual taxed at the top personal income tax rate who invested the amount in a personal savings account.*” (Emphasis added.) However, this statement is simply incorrect with respect to active business income subject to tax at the general corporate tax rate. Applying actual Canadian tax rates, the incorporated individual would be **disadvantaged** under this approach.

An individual carrying on business through a private corporation, which earns active business income taxed at the general corporate tax rate and invests the after-tax income, may be worse off under the elective method than if he/she had earned and invested this income directly. Assume that an individual directly earns \$100,000 annually and invests that money at a 3% annual return over a 10-year period. If that same individual had earned and invested the \$100,000 in a private corporation (taxed at the general corporate tax rate under the elective method) over the same 10-year period at the same 3% annual return, and then distributed all available cash in year 10 as a dividend, that individual would almost always be **disadvantaged under the Proposals**. The net worth comparisons across each province at the end of the 10-year period would be as follows:

Province	Individual (\$)	Corporation - Elective Method ¹² (\$)	Benefit of Incorporation (\$)
British Columbia	570,325	552,569	(17,756)
Alberta	566,771	540,950	(25,821)
Saskatchewan	569,732	556,123	(13,609)
Manitoba	538,460	492,867	(45,593)
Ontario	501,864	484,203	(17,661)
Quebec	504,424	478,093	(26,331)
New Brunswick	504,540	510,561	6,021
Nova Scotia	496,400	434,512	(61,888)
Prince Edward Island	527,079	489,253	(37,826)
Newfoundland and Labrador	527,899	433,757	(94,142)

In all but one province (New Brunswick), the individual who incorporated his/her business, and whose corporation has active business income taxed at the general corporate tax rate has a lower net worth under the Proposals when compared to an unincorporated individual. An individual resident in Newfoundland is disadvantaged by almost 10% of the \$1,000,000 of active business earnings.

Table 10 in the Proposals seeks to illustrate the neutrality achieved through the Proposals. The table attempts to compare an individual's net worth after earning \$100,000 in year one and investing the after-tax amount at 3% over a 10-year period. However, the assumed tax rates used differ from actual rates applicable in most provinces. If we replicate Table 10 using actual tax rates applicable in Ontario, the following results:

	Individual (\$)	Current (\$)	Default Treatment (\$) ²⁴	Elective Treatment (\$)
Income	100,000	100,000	100,000	100,000
Federal and Provincial personal or corporate tax	(53,530)	(26,500)	(26,500)	(26,500)
Starting Portfolio	46,470	73,500	73,500	73,500
Interest (3%)	1,394	2,205	2,205	2,205
Personal/Corporate Tax	(746)	(430)		
Non-Refundable Taxes			(1,106)	(1,106)
RDTOH		(676)		
After-tax investment income	648	1,099	1,099	1,099
Portfolio value after 10 years	53,370	85,257	85,257	85,257

¹² [Active business income subject to tax at general corporate tax rate, no RDTOH refund, and all dividends paid as eligible dividends.](#)

²⁴ It is not expected that the default treatment would apply where the general corporate rate applies, although this is what is illustrated in Table 10 in the Consultation Paper.

	Individual (\$)	Current (\$)	Default Treatment (\$) ²⁴	Elective Treatment (\$)
Refund of pre-paid tax (RDTOH)		7,236		
Distribution of eligible dividends		72,000 ²⁵	72,000	85,257
Distribution of non-eligible dividends		20,492	13,257	
Personal income tax on dividends		37,608	34,330	33,540
Net worth	53,370	54,885	50,927	51,717

Clearly, an Ontario resident individual, whose private corporation is subject to tax at the general corporate tax rate, is not made neutral under the elective method but rather is disadvantaged. In fact, the tax disadvantage under both the default and elective methods exceeds the tax “advantage” realized under the current system.

Extending the facts in Table 10 across all provinces shows the following comparative net worth after year 10:

Province	Net Worth After Year 10 (\$)				
	Individual	Current System (at small business rate)	Current System (at general rate)	Default Method (at small business rate)	Elective Method (at general rate)
British Columbia	61,110	65,113	62,015	60,022	59,057
Alberta	60,706	64,555	60,755	59,500	57,741
Saskatchewan	61,043	66,485	62,536	61,283	59,399
Manitoba	57,495	61,025	55,506	56,248	52,608
Ontario	53,370	58,510	54,885	53,932	51,717
Quebec	53,658	57,549	54,575	53,045	51,045
New Brunswick	53,671	58,095	56,858	53,533	54,356
Nova Scotia	52,757	56,993	49,344	52,505	46,140
Prince Edward Island	56,209	59,279	55,069	54,611	51,952
Newfoundland and Labrador	56,302	60,766	49,902	55,987	46,119

Under the default method (assuming utilization of the SBD), the net worth after 10 years, of an individual who has incorporated his/her business, is roughly equivalent to that of an individual who did not carry on business through a private corporation (although, in 8 out of 10 provinces, the results are still worse for the individual who incorporated in). Under the elective method (assuming application of the general corporate tax rate), in 9 out of 10 provinces, the net worth

²⁵ GRIP is limited to 72% of adjusted taxable income, notwithstanding that the combined general tax rate in a province may not be 28%.

of the individual who incorporated his or her business is worse after 10 years than the net worth of an individual who did not carry on business through a private corporation.

d) **Summary**

It is evident from the numbers above that:

- under-integration exists within the current Canadian tax system, which disadvantages individuals who choose to carry on business in a private corporation;
- the benefits of tax deferral, which allow a greater investment portfolio within the private corporation, may mitigate some or all of this under-integration disadvantage, depending on rates of return, investment periods and future tax rates, but it is more difficult to mitigate the under-integration effect in respect of active business income subject to tax at the general corporate tax rate; and
- with respect to investment income generated from active business income taxed at the general corporate tax rate, the elective method suggested in the Consultation Paper results in a material additional cost to the individual who chooses to incorporate, making him/her worse off than if he/she had carried on business and invested directly.

We strongly suggest that the Department of Finance closely analyze the numerical advantages of investing in a private corporation in the context of actual Canadian tax rates. We submit that any tax advantage realized by individuals who carry on business through a private corporation is highly uncertain, varies by province, and may not be realized at all. In addition, the advantage realized by individuals who carry on business through a private corporation where the SBD is available appears to be relatively modest.

We recommend that the Department of Finance carefully consider whether the complexity and confusion that would inevitably be created by enactment of the Proposals is an appropriate and measured response to the perceived inequity, when viewed in light of the actual potential benefits of carrying on a business and investing through a private corporation. If rules are introduced to deny the deferral advantage realized by private corporations with respect to investment income, it becomes especially critical for the Government to take into account the under-integration tax disadvantage faced by individuals who own incorporated businesses, and ensure that the actual (not merely theoretical) effect of the Proposals is to create tax neutrality.

We have one further observation on the effects of the Proposals. Some commentators have asserted that the Proposals will have no adverse impact on private corporations earning very low amounts of active business income (for example, under \$150,000). We believe these assertions are premised on the notion that the shareholders of such corporations will always be sufficiently well advised and nimble to circumvent the otherwise punitive effects of the Proposals by paying out all otherwise taxable income as salary or bonus. We believe this is not a realistic assumption. It both ignores the fact that commercial impediments (such as covenants to lenders or other creditors, not to mention the inappropriateness of paying out cash that may be needed to pay contingent liabilities of the business) frequently preclude the

annual payout of all otherwise taxable income from a private corporation to its owners. Indeed, the fact that a corporation has taxable income does not mean it has excess cash available to pay additional salary or bonuses, as that cash may be needed in the business for other purposes, including funding capital expenditures. Because the existing refundable taxes on aggregate investment income are premised on the individual shareholder being taxed at the top marginal rate, and because this is not the case for lower income business owners, the proposal to simply make these taxes non-refundable would result in over-taxation of many business owners (i.e., all such business owners who are not at the top marginal rate each and every year, and are not able to extract every dollar of otherwise taxable income as salary or bonus). We consider this to be a potential major design flaw that needs to be addressed in designing any legislation to implement the Proposals.

5. Experience in Other Jurisdictions

The Joint Committee has benefitted from reviewing several thoughtful commentaries made by others in the tax community over the past several weeks.

During the short consultation period, some commentators have managed to assemble an impressive volume of information regarding the foreign law treatment of investment income earned by private companies in some other jurisdictions. In their recent article published in *Tax Notes International*,²⁶ Nat Boidman and Michael Kandev describe the results of their comparative law analysis for 16 other jurisdictions.²⁷ Like Canada, many of the jurisdictions they canvassed have a significant gap between (low) corporate tax rates and (high) top marginal personal tax rates. (See also the chart above showing 16 countries with significant differences between high personal and corporate tax rates.) The Joint Committee believes that analyses such as this should be conducted in as systematic and thorough a manner as possible before any steps are taken to enact rules such as those described in the Consultation Paper.

In each of the 16 jurisdictions surveyed by Boidman and Kandev, private companies pay the same tax rate on investment income as applies to active business income. This obviously differs from the current Canadian rules, which impose refundable taxes on private corporations' investment income in order to mitigate the benefits of deferral by approximating the top marginal rate (approximately 50%) as the investment income is earned. Thus, the Canadian system already appears to mitigate the benefits of deferral to an extent not generally seen in other jurisdictions.

Furthermore, and of more direct relevance to the current Proposals, all but two of these jurisdictions appear to have no mechanism comparable to that now proposed in the Consultation Paper. As an example, the UK, like Canada, has a significant gap between (low) corporate tax rates (currently 19%) and (high) top marginal personal rates (currently 45 %), and

²⁶ *Tax Notes International*, September 4, 2017.

²⁷ Argentina, Australia, Belgium, Brazil, Denmark, France, Germany, Israel, Italy, Japan, Luxembourg, the Netherlands, New Zealand, Sweden, the UK and the US.

yet has no provision to impose special taxes on investment income derived by a private company from capital sourced from “lightly” taxed business income. Many of these jurisdictions, like Canada, generally seek to achieve horizontal equity. Yet, the different tax consequences visited on employees and business owners appear to be accepted from a tax policy perspective.

Boidman and Kandev note that the US does have a special tax applicable to “accumulated taxable income” of a private company that retains “excessive” earnings for passive investment. However, as they also note, this special tax almost never applies, and is therefore of very limited relevance in reality. Unlike the other jurisdictions surveyed by Boidman and Kandev (and unlike Canada), the US federal corporate tax rate (35%) is not much lower than the top marginal personal rate, and their system is clearly not integrated; as a consequence, private businesses in the US are most frequently organized as fiscally transparent LLCs or S-corporations, such that all of the corporation’s income is attributed to the individual owners, and taxed currently in their hands. Such a “pass-through” system, while failing to avail entrepreneurs of the advantages of low corporate tax rates, at least enables entrepreneurs to obtain limited liability without the “drag” of an under-integrated system such as that seen in Canada. Furthermore, it hardly needs mentioning that the US tax system is badly in need of reform, and that one of the current Administration’s priorities is to reduce the US tax burden. In our view, this suggests the present time a particularly dangerous one for Canada to increase the tax burden faced by entrepreneurs and innovators.

Only one surveyed country – Israel – has a special regime to essentially deem a private company to have distributed a portion of the cash retained in the private company and invested passively. However, this regime, introduced only this year, has numerous qualifications, safe harbours and *de minimis* exceptions, and notably applies only where the reason for the non-distribution is tax avoidance. These new rules appear to reflect a nuanced approach, in contrast to the indiscriminate type of regime described in the Consultation Paper.

While the authors themselves recognize the inherent limitations of their comparative law analysis,²⁸ in our view it is instructive that the regime contemplated in the Consultation Paper clearly does not appear to represent the norm for jurisdictions, like Canada, which have low corporate tax rates and high top marginal personal rates. This suggests that the competitive impact of any proposal similar to that described in the Consultation Paper could be significant and adverse.

This analysis reinforces our recommendation that no steps be taken to introduce such a regime before completion of a thorough and comprehensive study similar to that undertaken by the Advisory Panel on Canada’s system of international taxation. Such a study should include a

²⁸ They note, for example, that they did not specifically seek to determine whether distributing earnings would result in taxes that might be avoided or deferred by not making the distribution. Not surprisingly given the short consultation period, they also did not discuss such regimes as the Australian “personal services income” regime that can sometimes attribute active business income of a private company to the individual owners.

detailed review of the overall tax regimes of other countries in order to both benefit from existing best practices, and to avoid inadvertently putting Canadian private companies at a competitive disadvantage relative to private companies in other countries.

6. Comments on Alternatives Suggested in the Consultation Paper

The Consultation Paper states that the Government is considering changes to the tax treatment of passive investment income and describes three possible approaches, termed the 1972 Approach, the Apportionment Method, and the Elective Method in the Consultation Paper. The objectives, per the Consultation Paper, include preserving the intent of lower tax rates on active business income (“**ABI**”) to encourage growth and create jobs while limiting, to the extent possible, the complexity of the new rules.

As discussed below, it is not at all evident that passive investments made by private corporations do not encourage growth and create jobs. Moreover, as described above, the Canadian tax system already suffers from an under-integration of corporate and personal income taxes. While there is some deferral of tax on the ABI taxed at general rates and not distributed immediately to shareholders, that deferral is not significant, and at best serves to overcome the under-integration of corporate and personal income tax rates; and of course there is no deferral of tax on the investment income itself.

For the reasons described above, we believe no changes to the current system should be made without further study. Nonetheless, as the Consultation Paper seeks comments on the Proposals, we have provided below our comments on the alternatives raised in the Consultation Paper.

a) The 1972 Approach

The 1972 Approach, as described in the Consultation Paper, would involve retention of the current annual refundable tax on passive income but the addition of a second element, being an additional refundable tax on preferentially-taxed ABI used to acquire a passive investment (the “**additional refundable tax**”) which would be refunded when the corporation reinvested the amount in a business or paid the amount as a dividend to shareholders. The Consultation Paper suggests the Government is not actively considering this alternative at this time because it is concerned about the liquidity issues such a system would raise. We agree that such a system would inevitably raise liquidity issues, as well as other issues including the need to draw lines between ineligible investments and investments that should reasonably be regarded as incidental to the active business of the corporation or other corporations within the group. While we do not recommend pursuing the 1972 Approach, nonetheless it is notable that it is the least complex of the three alternatives raised in the Consultation Paper, notwithstanding that it, like all the alternatives, would require distinguishing between passive investments and assets reinvested in the business, in itself a complex endeavour (as discussed below). In our view, it could not be considered a viable option without significant changes to accommodate

the need for corporations to have excess cash and investments on hand for contingencies, expansion, business cycles, etc.

b) Apportionment Method

The Apportionment Method is one of two deferred-taxation methods described in the Consultation Paper. Unlike the 1972 Approach, the deferral methods described under the Apportionment Approach in the Consultation Paper would not increase current taxation of the corporate income and thus would not raise the same liquidity issues. However, this method would eliminate refundability of taxes on “passive income” not “reinvested in the business,” which could also raise liquidity issues over time.

The Apportionment Method contemplates tracking the source of funds used to acquire each investment asset as well as the income earned on each investment asset, with the tax treatment to the shareholder of a dividend paid being dependent on the sources of capital. The three sources of funds (or “**pools**”) mentioned are (i) business income taxed at the SBD rate; (ii) business income taxed at the general rate; and (iii) amounts contributed by shareholders from their after-tax income. All passive income would be taxed at approximately 50%, but the after-tax amount would be allocated among the pools based on taxation year opening balances. Passive income allocated to pool (iii) could be paid out “tax free”, but no taxes paid on that income would be refundable.

As the Consultation Paper points out, such a system would be very complex. In our view, the administrative and compliance costs associated with such a system could be significant and disproportionate. In addition to identifying which assets should appropriately be treated as passive investments, under this method the following are among the many issues that would have to be addressed:

- How will indebtedness be treated? Presumably loans advanced by shareholders would be treated in the same manner as paid-up capital. Would that also be true of arm’s length borrowing or borrowing from related or closely-connected persons who are not shareholders? While the debt must be repaid with after-tax dollars by the corporation, which after-tax earnings would be considered used? Would the debt financing be allocated among the pools in the same manner income is?
- How would losses be allocated? If a loss was realized in the business, would that be deducted from the three pools in the same proportions as the passive income would or only against the “business income” pools? If a loss is realized in respect of the passive portfolio, would that similarly be deducted from the three pools in the same proportions as passive income or only against the passive income pool? What if losses were carried back from one year to another? What if a loss realized in a taxation year before the regime was effective is carried forward to a post-effective date taxation year or vice versa? What if a loss is suspended or stopped?

- Would measuring the pools only at year end be appropriate? While this may have the very real and important benefit of simplicity (in an extremely complex system), it would risk being “rough justice” at best. Each of paid-up capital, debt financing, earnings, distributions, etc. balances may change monthly – or even daily. (We observe that for thin capitalization purposes, for example, retained earnings are measured at the beginning of the year while debt and paid-up capital are measured monthly, to seek an average for the year, although inconsistent measurement dates in those rules also raise issues.)
- If the corporation may elect which “pool” a dividend is paid from, what is the “penalty” for being wrong about pool balances, perhaps because of calculation errors or reassessments?
- Does a dividend from one private corporation to another retain its character (e.g., if it is designated out of the tax-paid capital pool of the dividend payer, is it added to tax-paid capital pool of the dividend recipient)?
- How would reorganizations, including amalgamations and “butterfly” or other reorganizations that divide up a corporation’s assets, affect a corporation’s pool balances?
- What if a non-passive asset with an accrued income gain (e.g., recapture) is transferred on a tax-deferred basis for an asset that is a passive asset? What if a passive asset is transferred on a tax-deferred basis for a non-passive asset? Are pool balances adjusted to reflect the redeployment of assets? Is there any special allocation for the tax-deferred gain?
- What if a passive asset becomes a non-passive asset or vice versa?
- Should any adjustment be made if there is an acquisition of control of the private corporation?
- How will section 49 gains on treasury shares be treated? Will that depend on how the invested funds are used?
- How will foreign exchange gains and losses be treated?
- What transitional rules will be needed where a corporation that was not subject to the regime (e.g., because it is a public corporation) becomes subject to the regime and vice versa?

The Consultation Paper states that the requirement to keep track of the three pools “could be seen as introducing new complexity in the tax system” but suggests that the required information is “either already computed for tax purposes or readily available to all corporations”. Our perspective is that there is no doubt this system would introduce significant additional complexity in a system that is already very complex. Moreover, even if the required information is readily available, about which we have some doubt, significant extra compliance costs will be associated with maintaining, and reporting, that information to the Canada Revenue Agency (“**CRA**”) and shareholders. This is on top of the significant complexity already added to the Act in respect of the SBD, most recently as a result of changes announced in the 2016 Federal Budget, as well as the changes made recently to subsection 55(2).²⁹ It may not be an exaggeration to say that a coherent set of rules to give effect to this system would give rise to complexity comparable to that of the foreign affiliate rules – to which a limited number of

²⁹ See submissions of the Joint Committee dated May 27, 2015, June 19, 2015, November 12, 2015, August 25, 2016, and October 13, 2016, to the Department of Finance, and June 2, 2017 to the CRA.

taxpayers are subject – in connection with the basic computation of income of small and medium-sized Canadian businesses.

To properly implement such a system in a manner that appropriately addresses the issues we have identified would, in our view, entail significantly more complexity than appears to be acknowledged in the Consultation Paper. In our view, the complexity and compliance costs associated with the Apportionment Method alone should be sufficient to discard it as a viable alternative and, our strong recommendation is that in no circumstances should the Apportionment Method be adopted.

c) The Elective Method

The Elective Method would not require tracking of sources of fund: rather, it would treat all investment income earned by a CCPC as having been funded from after-tax earnings subject to the SBD rate (as noted above, the “**default method**”), unless the corporation elected out (as noted above, the “**elective method**”). Under the default method, all investment income would be subject to tax at a rate approximately equal to 50%, but none of those taxes would be refundable. Dividends paid to the shareholders from such investment income would be treated as non-eligible dividends.

The main benefit of the default method is its relative simplicity. Nonetheless, it would raise substantially all of the questions raised with respect to the Apportionment Method. Additional issues that would need to be addressed include:

- Whether a corporation can use the elective method in one taxation year and the default method in the next (i.e., is the method to be selected for each taxation year?). If yes, when does the corporation decide on the method to be used (e.g., on filing its tax return for the year?) If not, presumably having used one method for a period of time, it would be open to the corporation to change to the other method?
- What would be the consequences to “existing balances” on transitioning from one method to another?
- What about losses realized in a taxation year to which one method applies but utilized in a taxation year to which another method applies?
- Having transitioned from one method to another, will the corporation have complete freedom in treating dividends it pays as being paid out of earnings taxed at the SBD rate, taxed at the general rate, or from passive investments?
- How would income on assets acquired from the shareholder or from investors in debt, equity or other securities of the corporation be treated?

Furthermore, where a corporation in fact earns business income that does not qualify for the SBD, or where tax-paid funds were contributed to the corporation, the resulting under-integration under the default method would be exacerbated.

While the elective method is relatively simple, it raises many of the same questions as the default method, particularly if circumstances change. For example, consider an associated corporate group that determines to allocate all of the SBD to Corporation X so that Corporation Y and Corporation Z pay tax at the general corporate rate. This arrangement continues for five years but in the sixth year Corporation X is sold, or Corporation X suffers a significant loss, such that it is desirable to allocate all of the SBD in the group to Corporation Y to the extent of its income and to Corporation Z for the excess.

Moreover, as discussed in detail above, where the business income is taxed at the general corporate rate, the combined corporate tax and personal tax paid when that income is distributed is higher than the tax that would be paid by the individual if the income were earned directly in all but one province. Accordingly, to add non-refundable taxes to the current taxes would not be neutral. The deferral of tax on the income not distributed should, in our view, be considered as at best ameliorating some of the higher tax payable as a consequence of the under-integration of taxes.

In summary, neither of the potential methods referred to in the Consultation Paper appears to us to be workable. If the Government intends to proceed with the passive income proposal, considerably more thought and study is required in order to develop a coherent and rational set of rules that are also workable. The challenge of achieving that objective should not be under-estimated.

7. Distinction between Business Income and Passive Income

If the Government decides to pursue any of the alternatives in the Consultation Paper, it will be critical for corporations and the CRA to be able to distinguish between “passive income” (“PI”) and “active income” (“AI”).

It is true that the Act currently contains rules for identifying “aggregate investment income” and “active business income”. The Act also distinguishes between dividends received by “connected” corporations and other inter-corporate dividends. However, those rules were designed for a different purpose, and have very limited consequences. Those rules are largely focussed on identifying income that is eligible for the SBD and income which should be treated as “aggregate investment income” and subject to the refundable tax regime. The Consultation Paper asserts that, generally speaking, the Government intends to continue to use “the distinction currently made in the tax system between active and passive sources of income...embedded in jurisprudence and...well-established.” We strongly believe that if the Government chooses to pursue a system in which the tax and compliance costs of earning PI are more significant than currently is the case, a coherent set of new rules, designed especially for this new regime, is needed to distinguish AI from PI.

As discussed below, the characterization of income under the existing provisions does not always accord with what a business person might consider to be the nature of the asset giving rise to the income. However, within the existing system, the characterization is more or less

accepted as achieving the right balance – bright line tests which sometimes might result in tax being said to be “prepaid,” but that tax is ultimately refunded when dividends are paid and, in the meantime, the refundable tax is an asset of the corporation (albeit a not an income-generating one). However, under the approach suggested by the Consultation Paper, the distinction between what is reinvested in the business, and what is not, is a critical determinant of the amount of tax ultimately paid on the corporation’s income. Accordingly, rules for making the distinction must be developed in that context.

a) Basic Definitions

As a preliminary matter, a decision must be made from a tax policy perspective as to what types of income earned by a private corporation will be classified as passive, and why. This may seem self-evident, but we believe careful thought is needed in circumstances where PI is to become subject to exceptionally high tax rates, as proposed. We suggest that the short consultation period is inadequate to carefully consider all aspects of this new distinction.

The Act already contains different definitions of the active/passive distinction, each of which is designed for the specific context in which it is intended to be used. These include the “aggregate investment income” definition (relevant for the purpose of determining eligibility for the SBD, the applicable corporate tax rate and the corporation’s RDTOH balance) in subsection 129(4), and the related “specified investment business” and related definitions in subsection 125(7), as well as the “investment business” and related definitions in subsection 95(1), which are relevant in the foreign affiliate area. The proposed, but never-enacted, FIE rules had their own bespoke definitions.

In the context of a new rule to impose exceptionally high rates of tax on the “passive” income of private corporations, we believe a nuanced and carefully targeted set of definitions is needed. Basic questions that must be addressed include the following:

- Should “income from property” be presumptively categorized as passive? If so, why? Economically productive activities such as software licensing may be categorized as generating income from property.
- Is a “more than 5 employee” test the correct way of distinguishing active from passive economic activities where income is derived from property? What about businesses whose core service providers are consultants rather than employees? Should there be an “equivalence” test such as that found in old Part XI?³⁰ Services provided by affiliates and partnerships should also be addressed.
- When should cash that is invested in “passive” investments be considered to be “properly” part of the business? Cash may be kept in a private corporation for

³⁰ The provisions formerly in old Part XI defining what was meant by a “substantial Canadian presence” included, as an alternative to the 5-employee test, a rule focused on whether expenditures for services performed in Canada exceeded \$250,000 annually.

numerous non-tax reasons, such as prudent cash management, the need to fund possible extraordinary expenses, capital investment, acquisitions, maintaining credit standing opposite lenders and other creditors, etc. Policy alternatives include qualitative tests (likely to foster disputes) or quantitative tests (such as the 36-month rule in the FIE proposals;³¹ potentially fewer disputes but rougher justice).

- How should inter-affiliate payments be dealt with? Active income should not become passive just because it is remitted from one company in the corporate group to another – for example as rent for real or personal property used in an active business, for services rendered intra-group to an active business or as interest on intra-group debt where the interest is deducted in computing the payor's active business income. The principles in subsection 129(6) and subparagraph 95(2)(a)(ii) already address this point. The "associated" standard in subsection 129(6) may be defensible in the context of the SBD (since associated corporations share the SBD), but is difficult to rationalize in the context of a new regime. Careful thought should be given to the appropriate test – alternatives include "affiliated", "non-arm's length" and the 10% votes/value test in subparagraph 95(2)(a)(ii). The rules will also need to address partnerships.
- How should inter-corporate dividends be dealt with? The "connected" test in section 186 suffers from serious anomalies. For example, it unusually requires ownership of more than 10% by votes and value (instead of 10% or more) of shares. And it has been interpreted as a "count-the-shares" rather than "count-the-votes" test, so that related persons may not be technically connected in some circumstances. These deficiencies, while tolerable in a system where the worst case is imposition of a refundable tax, cannot be defended in a system where high permanent taxes are to be levied. As discussed below, a very serious consideration of this issue is needed. Does a 10% test make sense in this context? Such a test would penalize an investment in, say, 9% of the shares of an active arm's length corporation. Does it really make sense from a policy perspective to impose non-refundable corporate taxes on the return on such an investment? Presumably, such a regime would cause fewer such investments to be made, thereby increasing the cost of capital of the businesses (many of them technology start-ups) thereby deprived of such investments. The consequential economic effects of such a change should be modelled and taken into account.
- How should losses be treated? Presumably the new system will need to distinguish "active losses" from "passive losses", much like the way the foreign affiliate system needs to categorize active losses from "foreign accrual property losses" or "**FAPLs**".

The above is by no means a complete catalogue of the issues to be considered in designing a new system. If the Government is to proceed, it is critical that it do so carefully, and in a way that minimizes the adverse economic fallout.

³¹ Paragraph (d) of the "qualifying entity" definition in proposed subsection 94.1(1), Bill C-10, passed by House of Commons October 29, 2007.

Below we elaborate further on some aspects of the active/passive distinction.

b) Capital Gains

The existing domestic rules for distinguishing AI from PI essentially treat all taxable capital gains from dispositions of capital property as PI, subject to refundable taxes on investment income. Unlike the foreign affiliate regime, the existing domestic regime makes no attempt to distinguish gains realized on the disposition of assets used in an active business from other gains. This “rough justice” does not give rise to unreasonable outcomes under existing rules given that the untaxed 50% of the capital gain is normally added to the corporation’s capital dividend account (“**CDA**”), which may be distributed on a tax-free basis to certain individual shareholders resident in Canada. The taxable 50% of the capital gain, if paid to individual shareholders, is taxable as a dividend. If it is not paid out, it is subject to the refundable tax regime applicable to investment income and is thus taxed at roughly the same rate as would apply had an individual realized the gain. This is the case regardless of whether the asset disposed of was one used in the business and whether the proceeds are reinvested in the business. Through this system, outcomes approaching (though in reality falling short of) perfect integration may be said to result.

The situation changes fundamentally if the currently temporary (i.e., refundable) corporate taxes on the taxable capital gain become permanent. This is exacerbated if the CDA system is upset in the name of “fairness”, as proposed in the Consultation Paper.

We believe that if the Proposals regarding taxation of passive investments are to be pursued, the treatment of capital gains needs to be re-thought. Private corporations engaged in successful active businesses not only produce business income, which is taxed as it is earned, but also may appreciate in value. Appreciation may be the result of any number of factors, including the creation or enhancement of goodwill, the development of trade names or brands, discovery of a technological breakthrough, valuable supply or distribution agreements, appreciating land values, or endorsements, to name but a few. If and when the corporation disposes of a tangible or intangible capital asset used in the business, the resulting gain does not conceptually resemble a passive return; rather, the gain essentially represents the current realization of expected future cash flows from the business. It follows that there is a fundamental distinction between capital gains realized from disposition of an asset used in an active business and other capital gains (for example, from disposing of a publicly-traded portfolio investment).

This distinction is recognized in the foreign affiliate rules. Those rules draw a distinction between property used in carrying on an active business (defined as “**excluded property**”) and other property. Taxable capital gains from dispositions of excluded property generally are excluded from the definition of “foreign accrual property income” (“**FAPI**”). Such gains are not imputed to the Canadian resident shareholder. Depending upon whether the property disposed of is in a treaty jurisdiction, such gains are, at worst, instead taxed only upon

distribution of any part of the capital gain, either through taxable surplus or through the “hybrid surplus” regime.

The excluded property definition takes account of the possibility that the disposing affiliate may dispose of an active business by selling shares of a lower-tier subsidiary. Excluded property is thus defined to include shares of a foreign affiliate that derive all or substantially all of their value from property used in an active business.

While it is recognized that the foreign affiliate system was designed to achieve different legislative objectives, we nonetheless believe these rules provide a possible starting point for designing a coherent system for distinguishing AI from PI in any new system for taxing private corporations. Conceptually, it seems appropriate to us that the taxable capital gain derived from a disposition of an asset used in an active business should be regarded as AI and the accompanying non-taxable portion should be added to CDA. Conversely, the treatment of such gains as PI seems fundamentally flawed. Moreover, under any such new regime, rules will need to be developed, similar to those applicable to excluded property in the foreign affiliate context, to treat shares and other capital investments³² in certain corporations as excluded property, and the capital gains realized on such investments as AI rather than PI.

Rules would have to be introduced to distinguish investments in corporations that are not sufficiently meaningful to warrant treatment as excluded property. In our judgment, a 10% test, similar to the foreign affiliate definition, may be an appropriate way to distinguish shares in corporations carrying on an active business that should be considered to be held in an investment portfolio from those that should not, but as noted above a lower threshold may also be appropriate in the domestic context for these purposes. Furthermore, shares of a foreign affiliate that meet the current excluded property definition (i.e., all or substantially all property of the corporation is used in an active business) ought, for the same reasons, to be classified as excluded property under the new regime, such that capital gains realized by a private corporation from the disposition of such shares should be treated as AI not PI.

We note that with respect to gains derived from the disposition of goodwill, trademarks and certain other intangibles, until the recent replacement of the “eligible capital” regime with new Class 14.1, the taxable portion of those gains was for many years treated as business income. The replacement of the eligible capital regime with Class 14.1 does not appear to have been designed with the potential passive income changes described in the Consultation Paper in mind. Accordingly, it is reasonable to suggest that the treatment of gains from these types of intangibles needs to be considered particularly carefully. Goodwill generally arises from the successful pursuit of a business. It is the product of entrepreneurs’ hard work and, in some cases, good fortune. We believe it is particularly inappropriate to treat the gains derived from disposition of goodwill as PI, as such gains fundamentally represent a form of return from having carried on a successful business.

³² For example, foreign-currency denominated debt or convertible debt of those corporations.

c) Many Investments Currently Subject to the Existing Refundable Tax Regime Actually Support Economic Growth and Job Creation

We understand that the Proposals are not intended to adversely affect corporations that do not earn passive income, or which earn such income but invest it in a business to earn business income. The rationale for retaining these aspects of the current rules with respect to business income seems to be as follows:³³

The initial benefit from the lower corporate tax rates would also be preserved when the corporate owner reinvests its passively-invested funds to expand the active business.³⁴

This will help to ensure that our corporate tax system continues to support economic growth and job creation.

In other words, the Consultation Paper distinguishes between income which is subject to the existing refundable tax regime (referred to as “passive income” and to be treated as “bad” income), and all other income (treated as “good” income). The stated rationale for this distinction appears to be a presumption that the latter supports growth and job creation while the former does not. As noted above, we believe the existing distinctions between AI and PI need to be rethought if the Proposals are to proceed. It is also the experience of some members of the Joint Committee that prospective business owners do not typically make the fine distinctions noted in the Consultation Paper. Rather, some prospective business owners may see the tax environment growing more hostile to innovative activities (by imposing non-refundable taxes on investment income from business profits set aside for future consumption, including to expand the business or start a new business), and react by establishing fewer new businesses in Canada.

In any event, we submit that the Government’s presumption may not be sound. The current refundable tax regime is drafted to apply to passive investments, irrespective of whether they support growth or job creation. Many investments which support growth and job creation are nonetheless subject to the current refundable tax regime. The following examples illustrate the rather arbitrary tax treatment of different types of investments that would result under the Proposals using the existing refundable tax regime:

³³ See page 52 of the Consultation Paper.

³⁴ Although this statement refers to “the” active business, we assume it must include both the business from which the earnings were derived and a new active business.

<u>Investment</u>	<u>Treatment</u>
Direct investment in virtually any business (in Canada or out, employees or not), irrespective of ownership level	Good
Indirect investment through partnership in virtually any business, irrespective of ownership level	Good
Indirect investment through a personal trust carrying on business, irrespective of ownership level	Good
Indirect investment through a mutual fund trust, irrespective of ownership level	Good but could be structured to be Bad
Indirect investment of significant stake (10%) through shares of a corporation (public or private, in Canada or out, carrying on any activity)	Good
Indirect investment through shares of corporation where less than 10% is owned	Bad
Debt advanced to associated corporation for active business	Good
Debt advanced to non-associated corporation for active business	Bad
Gains on shares held as inventory	Good
Gains on shares of a non-controlled active Canadian corporation held as capital property	Bad
Gains realized by a foreign affiliate on shares of a non-controlled active foreign affiliate held as capital property	Good
Land held as inventory (e.g., by speculator to “flip”)	Good
Land held as capital property (e.g., to rent to an unrelated business)	Bad
Hotel that employs two part-time persons	Good
Mobile home park that employs two full time persons	Bad
Treasury funds held to support a performance bond relating to an existing active business	Good
Treasury funds held to support a future expansion of an active business or active business acquisition	Bad

Many members of the Joint Committee believe government policy should not be designed to pick “winners” and “losers” in this manner. However, if the Government wants to implement a tax system that creates an incentive to make certain investments because those investments

are believed to support growth and job creation, then there should at least be some attempt to actually identify investments that achieve that purpose, and distinguish them from those that do not. The existing refundable tax regime clearly makes no attempt to do so, and was not designed with that objective in mind.

Therefore, as noted above, the existing regime is not a good starting point for distinguishing between desirable investments and investments the Government wishes to discourage.

d) Incentive Effects of Non-refundable Taxes

The Carter Report³⁵ concluded that a tax system should be neutral, meaning that it should be designed to minimize distortions in the allocation of resources. Most economists appear to agree with this principle, and we believe it continues to be sound. As a general matter, we believe it is in the best interests of Canadians that our tax system be designed to minimize distortions.

The Proposals will result in different tax rates on certain types of income, or even on the same type of income depending on the source of the investment capital. It seems very likely that taxpayers facing such tax rates will strive to avoid making investments that will be subject to that tax, in favour of making other investments that will not be (or will simply spend money they otherwise would save). Given the rates of tax involved, we submit that this feature of the Proposals is concerning in light of the neutrality principle. The Proposals would impose a higher rate of tax on savings, thereby tending to deter taxpayers from saving and potentially creating an incentive in favour of generally riskier investments. We submit that this is not a desirable feature of a tax system.

In our view, at a minimum, the Government should consider the extent to which the Proposals will cause behavioural change which: (i) results in sub-optimal investment decisions which reduce both real wealth for taxpayers and Government revenues; and (ii) results in the Proposals being avoided which makes them ineffective in achieving the desired objectives or raising Government revenue.

In designing the new regime, and analyzing the likely economic ramifications of its enactment, the behavioural reactions of taxpayers should be anticipated. These may include adopting different business structures (even at the cost of sacrificing limited liability), seeking to make otherwise “private” corporations qualify as “public”, establishing new businesses or moving established but mobile businesses (e.g., service or technology-based businesses) to another country, and utilizing other structures.

Debt investments (including GICs, bonds, savings accounts, etc.) generally would be avoided except in very narrow circumstances involving a loan to an “associated” corporation (unless of course, contrary to our suggestion, the active/passive distinction is based on a concept other than “association”). Under the existing rules, it is already impossible to keep up with inflation

³⁵ Canada, Royal Commission on Taxation, *Report* (Ottawa: Queen’s Printer, 1966) (Chair: Kenneth Carter).

on such investments, unless material risk is taken on, because the current system levies tax on inflation rather than on real returns, tax rates are high, and yields are low. The Proposals would exacerbate these existing issues.

Share investments in dividend-paying corporations generally would be avoided in favour of capital-appreciating stock. In addition to seeking to defer tax, a taxpayer might make such an investment to gamble on a future legislative change which eliminated the rules before they have any consequence to the taxpayer. Even if the rules are not changed, the strong incentive created by the Proposals to buy and hold capital-appreciating investments would exacerbate the “lock-in effect” of taxing capital gains, resulting in further market distortion.

Equity investments in large public market entities would be avoided in favour of private equity investments (in a business directly, through a partnership or joint venture or in a corporation in which the investor would own more than 10% of the shares), thereby resulting in the Proposals being inapplicable. It seems likely that such investments would tend to be riskier and often would entail fewer of the protections that Canadian securities laws have been designed to provide.

Businesses which were leasing office space, because it was the smart business decision, will be motivated to use funds that otherwise would be invested in passive investments to purchase office space, thereby effectively investing capital in real estate rather than suffering the rates of tax contemplated by the Proposals.

Corporations which concluded that some amount of debt is optimal in light of current interest rates, will be motivated to use funds that otherwise would be invested in passive investments to eliminate any debts, thereby achieving a sub-optimal debt/equity ratio only to avoid the imposition of the exceptionally high tax rates contemplated by the Proposals.

Rather than investing in productive real estate which would generate rent that would be subject to higher tax rates, a corporate investor may have the incentive to acquire speculative, non-income producing properties, and to realize profit by reselling at a profit.

Rather than passively investing in the stock market, investors would be motivated to “quit their day job” and take an active role in trading the investments so that the activity constitutes a business, and the resulting income is taxed as business income.

If the rules are to be changed to address the perceived unfairness of the current system described in the Consultation Paper, we strongly urge the Government to model the likely fiscal and macroeconomic impact of the changes having regard to the behavioural changes that can reasonably be expected to flow from this dramatic change in tax policy.

8. Transition

The Consultation Paper states that the new regime will apply “on a go-forward basis”.

What exactly does this mean?

As a general matter, we believe that taxpayers’ faith in the overall fairness of the tax system depends critically on the assumption that they can rely on the Government not to enact retroactive or retrospective legislation. Indeed, it is our understanding that the Government does not intend that the new regime apply retroactively or retrospectively. This is important. A fundamental feature of a fair tax system is that it protects the legitimate expectations of taxpayers who arrange their affairs in reliance on the incentive pattern created by the legislative scheme. We reiterate that the proposed passive income amendments do not constitute the closing of any “loopholes”, and that the proliferation of private corporations in which wealth from business operations may be accumulated is a natural and foreseeable consequence of policies consciously adopted by the current and prior governments, to the extent it is tax-motivated at all. This makes it all the more important to create nuanced and carefully crafted rules that treat the accumulated assets of existing business owners (and future income derived from those accumulated assets) as if the new rules had not been enacted.

A transitional rule that simply provides that income earned before the “coming-into-force” (“**CIF**”) date of the new regime is exempt from the new rules would obviously fail to protect the legitimate expectations of taxpayers. While it is true that the existing refundable dividend tax on hand (“**RDTOH**”) and CDA balances would be untouched, these taxpayers would be “trapped”. Their assets would be “stuck” in corporate solution, and future investment income on the accumulated assets would instantly become subject to non-refundable corporate taxes that could not have been anticipated when the structure was established and the investment portfolio was established. Furthermore, as noted above, due to under-integration, future business income would be subject to higher taxes than if it had been earned directly by the individual shareholders, but the advantage of tax deferral – the one feature that currently permits business owners to mitigate the adverse effects of under-integration – would effectively be lost.

Another inadequate approach would be to “grandfather” only the income derived from the “existing” investments actually held on the CIF date. This would arbitrarily penalize taxpayers who hold short-term investments (e.g., one-year GICs) and would arbitrarily reward taxpayers who hold longer-term investments (e.g., long-term bonds or shares of corporations). Furthermore, a “lock-in” incentive would be created under which investments that might otherwise be disposed of as non-performing would be retained in order to avoid the imposition of the new non-refundable taxes on income derived from reinvesting the net proceeds.

A more defensible transitional rule would need to contemplate a “V-day” determination of all “passive” assets (as defined) held on the CIF date. A special account will be needed to track the income from those assets. Income from reinvestment of that income, income derived from the

reinvestment of proceeds of disposition of any of those assets, and any losses derived from those assets (all computed as if the corporation owned no other assets, had no other income, and no other losses) should be computed, and the existing regime (instead of the new regime) should continue to apply to those amounts. Based on the limited time available to consider this matter, we do not have any specific drafting recommendations, but we do observe that it is absolutely critical to get the transitional rule “right”. It is one thing for the Government to change the rules going forward, but for taxpayers to feel like they relied on the longstanding rules to their detriment can do irreparable harm to the integrity of the tax system.

Other questions that would have to be addressed include the following:

- How will “grandfathered” CDA and RDTOH balances flow through corporations where dividends are paid from one private corporation to another after the CIF date?
- If a capital loss is realized on a passive asset subsequent to the CIF date of the new regime, will that impact effective date CDA balances? We suggest they should not, unless a capital gain on the same asset would result in an addition to the CDA balance under the new regime.
- Where a corporation has a grandfathered RDTOH balance, will post-CIF date dividends be considered to automatically result in a refund of tax, or will the corporation be able to elect to treat the dividend as having been paid out of active business earnings or post-CIF date passive income?
- How should adjustments be made for losses realized in taxation years before the new regime is effective, but deducted in taxation years after the new regime is effective? What about losses realized in taxation years after the new regime is effective and carried back to a pre-CIF date taxation year?
- How will the rules apply to corporations that have a taxation year that straddles the CIF date?

Moreover, policy alternatives should be considered to address taxpayers “trapped” in structures that were encouraged by the old rules, but are now discouraged by the new regime, and which would be expensive to unwind. De-incorporating a business is generally impossible on a tax-free basis unless special rules are enacted to facilitate this (similar in concept to the rules that allowed income trusts to convert to taxable corporations when the SIFT rules came into effect). For many businesses, de-incorporation is undesirable because, contrary to the perspective reflected in the Consultation Paper, business people in fact incorporate for many non-tax reasons. But, for those businesses that might be willing to sacrifice limited liability rather than be subjected to higher tax rates on investment income, one potential alternative would be to adopt a de-incorporation rule similar to the SIFT conversion rule.

Another potential approach would be to provide taxpayers with a “check-the-box” system under which business owners could elect to have the results of future operations reflected in their personal tax returns. Absent any other changes to the taxation of business income, this would undermine any remaining “benefits” associated with “low” corporate business income tax rates (including the SBD). However, some taxpayers clearly would prefer to pay personal tax on all of the corporation’s income rather than pay the under-integrated corporate and personal rates, be subject to the new non-refundable regime which eliminates the benefits of deferral, and be burdened with the significantly higher compliance costs anticipated under the Proposals. Such an approach, unlike de-incorporation, would also preserve limited liability. Clearly, considerably more thought and consideration is required.

9. Other comments

a) Extending the Proposals to Non-CCPC Private Corporations Could Reduce Tax

One of the questions posed in the Consultation Paper is whether the refundable tax regime should be extended to non-CCPC private corporations.³⁶

We note that extending the refundable tax regime to non-CCPC private corporations, on its own, could actually reduce government revenues. In particular, where a non-CCPC private corporation is owned by non-residents, extension of the existing refundable tax regime to such entities would reduce corporate income tax on royalties, interest, capital gains and other investment income earned by such corporations, typically without a corresponding increase in shareholder-level tax (because non-residents will be subject to a withholding tax rate as low as 5% under Canada’s treaties when dividends are paid to eliminate the refundable corporate tax). This is because the combined federal/provincial non-refundable tax rate is lower than the general corporate tax rate in all provinces). Indeed, we understood that this factor has been an important reason for not extending the existing rules beyond CCPCs for decades.

For example, under the existing rules, a non-CCPC corporation taxable only in Alberta that is owned by a non-resident corporation would pay corporate tax on a capital gain of 13.5%, leaving 86.5% to be distributed as a dividend. Assuming a 5% treaty withholding tax rate, the combined Canadian taxes under the existing regime would be approximately 18%. If, instead, the non-CCPC were subject to tax under the refundable tax regime, it would be subject to approximately 25.3% corporate tax on the capital gain, but approximately 15.3% of that corporate tax would be refundable, for net corporate tax of only 10%, leaving 90% to be distributed as a dividend. The combined Canadian taxes in that case would decline from approximately 18% of the gain to approximately 14.5%. To the extent the non-resident is subject to tax in the non-resident’s local jurisdiction, such that any Canadian tax is creditable

³⁶ We observe that it is not entirely accurate to say that only CCPCs are subject to the current refundable tax regime. Private corporations and subject corporations (whether CCPCs or not) are already subject to the existing refundable Part IV tax regime with respect to dividends.

against foreign tax, extending the refundable regime would effectively be a transfer of taxes from Canada to the foreign jurisdiction.

On the other hand, inbound investments including portfolio investments can be beneficial to the Canadian economy. Inbound investments structured through Canadian-resident corporations can in certain cases be taxed at higher rates than if they had been made directly. For example, capital gains from the disposition of property that is not “taxable Canadian property” or that is “treaty protected property” are not taxable if realized directly but are taxed if realized through Canadian-resident corporations.

We recommend that the Government model the extent (if any) to which a change would affect government revenues and the attractiveness of Canada as a location for international investments.

We further note that currently only CCPCs are eligible for the SBD, the LCGE for shareholders, refundable SR&ED credits and various other incentives. If the refundable tax regime is extended to some or all non-CCPC private corporations we recommend that the Government also extend other rules that currently only apply to CCPCs or articulate principled reasons for not extending them.

At the same time, if the regime applicable to CCPCs does not apply to private corporations that are not CCPCs, as noted above, consideration will have to be given to the consequences to a corporation that ceases to be a CCPC and when a corporation should be considered to lose CCPC status for this purpose.

More generally, we would note that the basic “fairness” issue which lies at the core of the Proposals is simply not present in the case of a foreign-owned private company. Such a company is, by definition, not used by a Canadian resident individual to pay less Canadian tax, as the owners are non-residents. Furthermore, any changes affecting foreign-controlled companies would presumably need to be accompanied by changes to the branch tax rules, which could raise treaty issues. Rules would also need to be developed to deal with private corporations with a mix of shareholders (i.e., some (but not all) of whose shareholders are non-residents of Canada). Should the new regime apply partially to such corporations? This might address potential policy concerns, but would inevitably give rise to yet more complexity.

Fundamentally, given the articulated rationale for the proposal, we generally think it makes sense for it to be confined to CCPCs.

b) Dividend Refund Generated by Dividend from Business Income

The Consultation Paper correctly observes that it is possible to obtain a dividend refund by paying a dividend sourced from active business income. The Consultation Paper also posits that

this result may not be consistent with the spirit of the rules. The implication, though not stated as such, is that these existing rules may change, possibly with retroactive effect.

We have difficulty understanding from a policy perspective why the physical source of the cash for a particular dividend should affect its treatment. Cash is fungible. This is more of an ordering issue than one that should be linked to the physical source of cash. Alternatives in this regard include apportionment, best treatment first, worst treatment first, elective ordering, etc. Many regimes in the Act give rise to this type of issue, and in general the best treatment first or elective approaches are taken.

In addition, we do not see a net benefit where a corporation pays a dividend sourced from active business income and obtains an RDTOH refund. Based on computations we have prepared, the Joint Committee believes there is no material advantage realized by an individual who has incorporated his or her business and causes the corporation to annually pay out eligible dividends sourced from active business income sufficient to fully refund the RDTOH balance.

We note that the CRA has confirmed its view that a dividend refund can be obtained with a dividend sourced from business income. Specifically, the CRA observed that “[t]here is no ordering or tracing of the dividend payment to the type of income earned by the CCPC. If a CCPC has a combination of aggregate investment income and GRIP, the rules provide that this result will occur.”³⁷ The CRA has ruled that such a dividend is not an excessive eligible dividend and that the general anti-avoidance rule does not apply (*i.e.*, by necessary implication the CRA ruled that the result is not inconsistent with the object, spirit or purpose of the rules).

In our view, the CRA’s ruling on this point is unassailable under the current law. Accordingly, any change to the rules in this area should be made only on a prospective basis with appropriate grandfathering.

If these rules are to be changed to prevent the result described in the Consultation Paper, we note that complex tracing or apportionment concepts appear to be required. We recommend that the Government model the anticipated fiscal impact of the changes and consider whether the additional complexity is warranted. We suggest that the drafters of the existing eligible dividend rules would have been well aware that many corporations earn both investment income and active business income and accordingly, these drafters made the deliberate decision to not introduce complex tracing or apportionment concepts at the time the existing eligible dividend rules were introduced.

Furthermore, in our view, the Government should carefully and more broadly consider how the principle of integration would be preserved going forward where a mix of active business income and investment income is earned, including in tiers of corporations, some of which may have active business income and others investment income.

³⁷ Ruling 2007-0231521R3.

10. Targeting Professionals

The Joint Committee recently learned that some commentators have expressed the view that changes to the taxation of passive income of private corporations ought to apply only to certain “professional” businesses. One commentator specifically identified successful doctors, lawyers and accountants as the “real” target of the passive income proposals.

The Joint Committee disagrees with the assertion that any proposed measures should target only these or other specified “professional” businesses. There is in our view no coherent basis for distinguishing a business that is a “professional” practice from other businesses for this purpose. Indeed, proposed amendments introduced as part of the 2017 Budget seek to “level” the playing field between those professional businesses identified in section 34 (which permitted the professionals identified therein – including veterinarians and chiropractors – to compute income on a “billed” basis) and all other businesses by repealing that provision. Having decided to treat such businesses the same way as other businesses, we are not aware of a rational basis for now penalizing such businesses by applying a new tax regime only to them and not to other businesses.

Some professionals can be hired as employees but those who are self-employed are undoubtedly engaged in business activities, and, as such, create employment opportunities for others and bear the risk of loss. Well known examples of business failures of professional undertakings in Canada – including large law firms - attest to the hard truth that professionals engaged in private practice are carrying on business, with all of the attendant risks, and are not employees.

We also question whether a rational case could be made for any particular definition of “profession” for this purpose. In addition to those noted above, other professions include the businesses carried on by architects, engineers, psychologists, management consultants, IT consultants, interior designers, landscapers, geologists, project managers, and an endless list of other professions, including many in cutting edge sectors of the “knowledge economy”. We believe any attempt to define “professionals” for this purpose would be rooted in an arbitrary distinction.

We also note that horizontal equity among different persons carrying on business would be undermined by a rule that singled out professionals for special adverse tax treatment not applicable to persons carrying on other businesses. Professional businesses are really a subset of the service economy – which is widely understood to be the sector of the economy that is expected to contribute an increasing share of overall economic growth in coming years, as the knowledge economy becomes more prominent. Furthermore, professional businesses, including large accounting and law firms, employ a significant number of Canadians.

We acknowledge that the Government has not suggested targeting any measures at professionals, but, as this suggestion has been made by others, we thought we should provide our reaction.

11. Concluding Statements

The July 18 passive income Proposals are far-reaching, and represent a significant departure from existing tax law and policy. Since publication of the Consultation Paper in mid-summer, various industry and professional groups have commented. It is clear that the Proposals have generated considerable division and controversy. In our view, the heated environment is all the more reason for the Proposals to be considered in a measured and transparent manner, with due care. A successful reform of these sensitive tax rules hinges to a significant extent on obtaining widespread (though realistically not universal) “buy-in”. A divisive, politically charged, approach, in which certain classes of taxpayers are said to have access to “special” and “unintended” benefits to the detriment of others, or inaccurately said to be exploiting “loopholes”, is not, in our respectful submission, constructive or conducive to a successful reform of our tax laws.

The Joint Committee remains available to discuss this submission or any related matters with you in person or by telephone.

Appendix A

Proposed Terms of Reference for an Advisory Panel

Below we set out a preliminary list of items that could be incorporated into the terms of reference of an Advisory Panel mandated to review the taxation of private corporations and their shareholders.

- The (in)effectiveness of current rules intended to produce integration, including with regard to business income, investment income, and capital gains.
- The complexity of the Act and potential reforms, and their impact on the efficiency of a self-assessment system, including both compliance costs for taxpayers and administrative costs for government.
- Alternative approaches to the taxation of private corporations and their shareholders, including integration, flow-through, and other alternatives.
- International comparative reviews of:
 - the taxation of private corporations and their shareholders,
 - the extent of the gap between personal and corporate rates,
 - the extent, if any, to which the system differentially taxes passive as opposed to active income of private corporations,
 - the tax mix, including corporate income taxes, personal income taxes, and value-added taxes, and
 - savings rates and regimes for individuals, including business operators and employees.
- Impact of potential reforms on overall economic activity, including:
 - the relative impact on job creation and growth of “active” versus “passive” investment,
 - the impact of potential reforms on effective tax burdens on small and family-owned businesses,
 - the impact of potential reforms on administrative and compliance burdens on small and family-owned businesses,

- the impact of potential reforms on business confidence and investment rates of small and family-owned businesses, as well as start-ups and innovators,
 - the relationship between the success of small and family-owned businesses and the health of local communities,
 - the relationship between the success of small and family-owned businesses and the success of large businesses and public corporations, and
 - the differential impact on job creation and growth in the various provinces and territories.
- Federal and provincial/territorial revenue implications.
- The impact of potential reforms on Canadian versus foreign ownership of Canadian private and public corporations.
- Gender implications of potential reforms.
- Implications of potential reforms for youth.