Private Corporation Tax Proposals: In the right direction?

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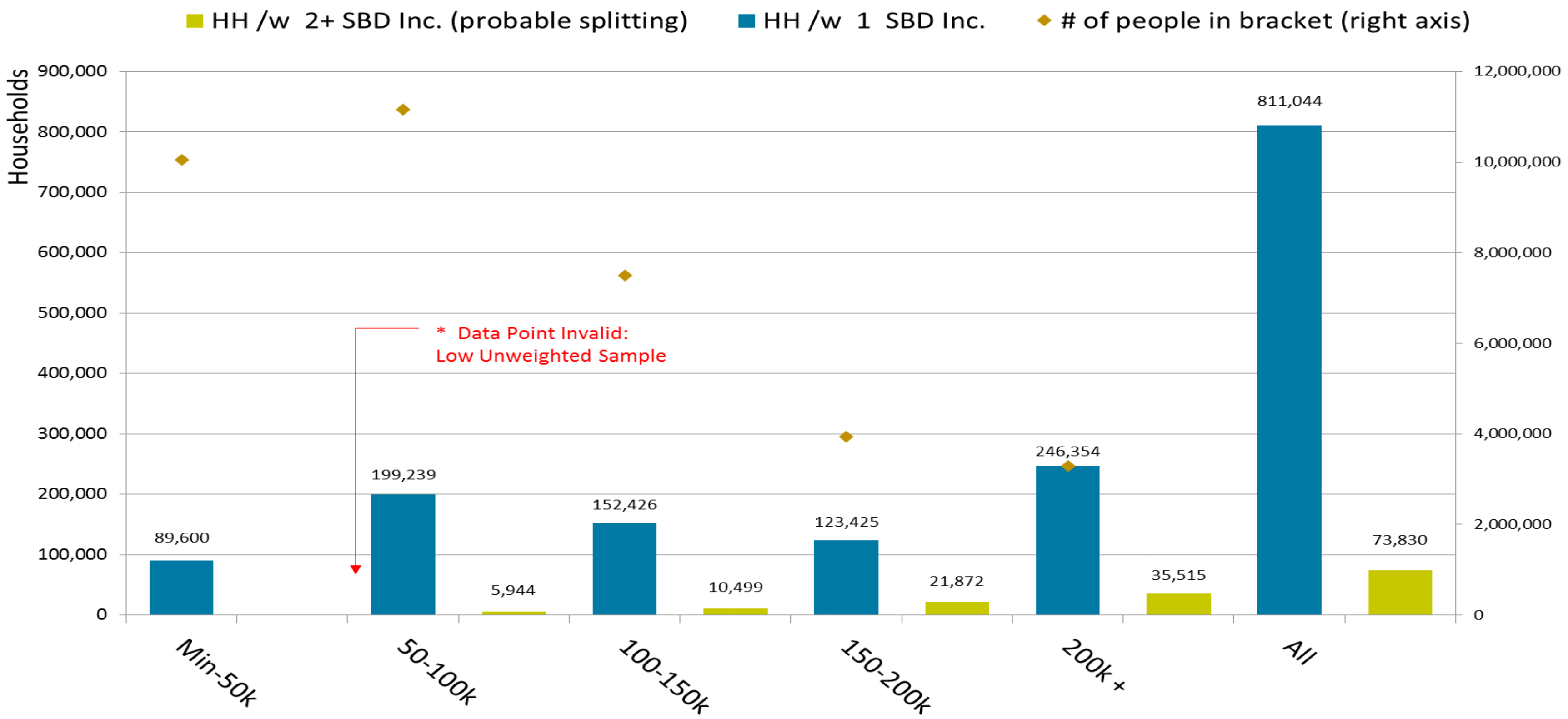
Outline

- Tax Principles for Tax Reform
- Current weaknesses with private corporation and small business taxation
- July private corporation proposals
- Evaluation
- Other options

Fairness is not the only principle for a good tax system

- Economic efficiency: minimize distortions through neutrality
  - Improve economic growth and job creation
  - Reminder that taxation of investment income is a double tax on savings (expenditure tax removes double tax on savings)
- Fairness:
  - Horizontal equity: equal treatment of equals
  - Vertical equity: tax more who have more resources
- Minimize compliance and administrative costs

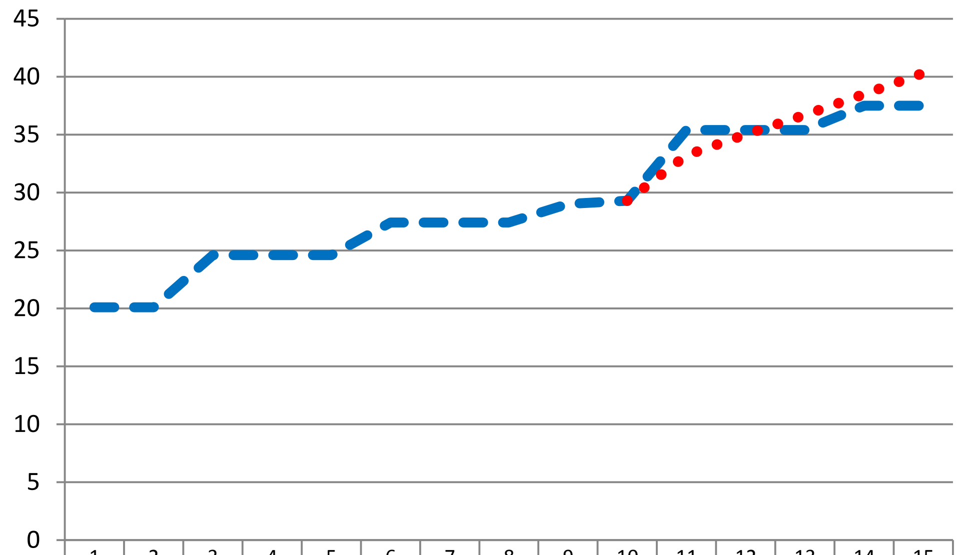
Many private corporations pay dividends to households who are not the very rich



Weaknesses of existing taxation of business income

- Economic efficiency:
  - Certain tax benefits to incorporate compared to self-employment:
    - Easier to split income through share ownership.
    - Deferral of tax with low corporate tax rate with favourable capital gains tax on disposal of shares.
    - Ability to average personal income by timing distributions.
  - Certain tax disadvantages to incorporation:
    - Heavier tax on risk as losses trapped in corporation (lack of full loss offsetting and averaging under the personal income tax increases tax rate on risky businesses)
    - Passive income taxed at high rates more than 50% by province.
    - Dividends and capital gains are not “earned income” to qualify for RRSPs.
  - Current structure of tax incentives rewards being small – tax wall on economic growth due to small business deduction, LCGE limit, progressivity of marginal tax rates.
  - Canada is not competitive with the US for successful start-ups primarily due to high personal tax rates.

Taking into account progressivity, small business METR doubles with growth



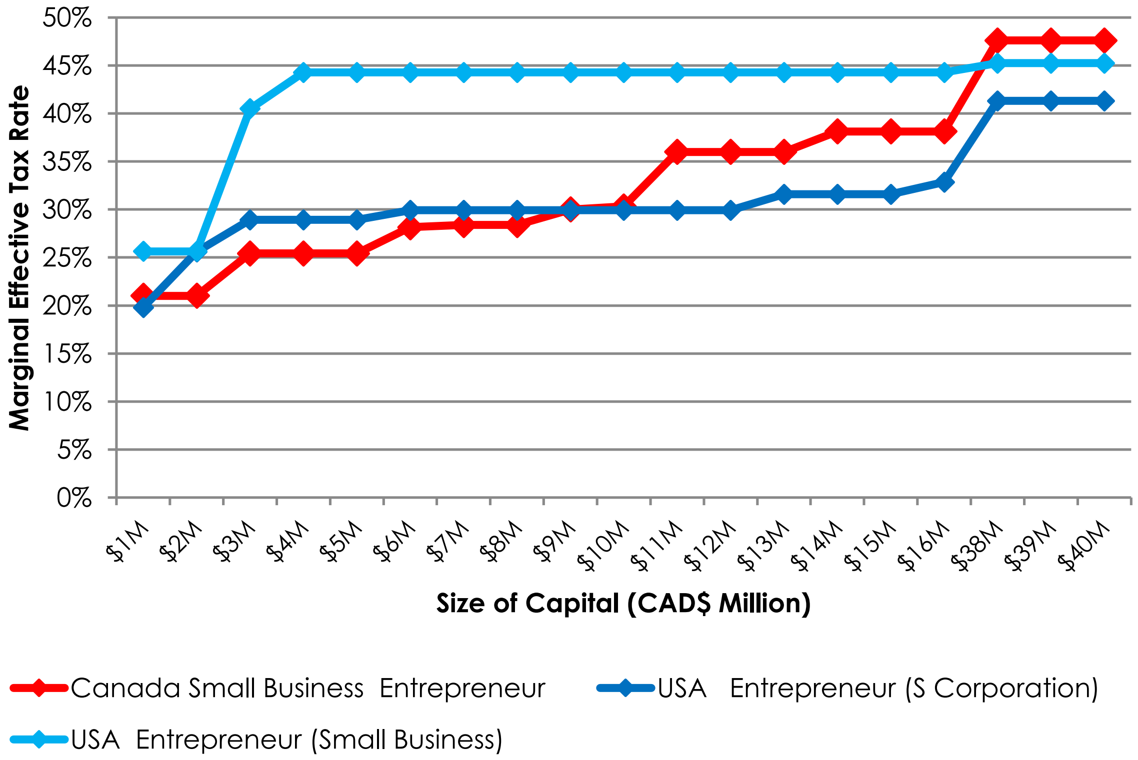
	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15
METR for Small Business (Percentage)	20.1	20.1	24.6	24.6	24.6	27.4	27.4	27.4	29	29.3	35.4	35.4	35.4	37.5	37.5
METR for Small Business with Increased Debt (Percentage)										29.30	33.2	35	36.7	38.50	40.3

Size of Capital (CAD$ Millions)

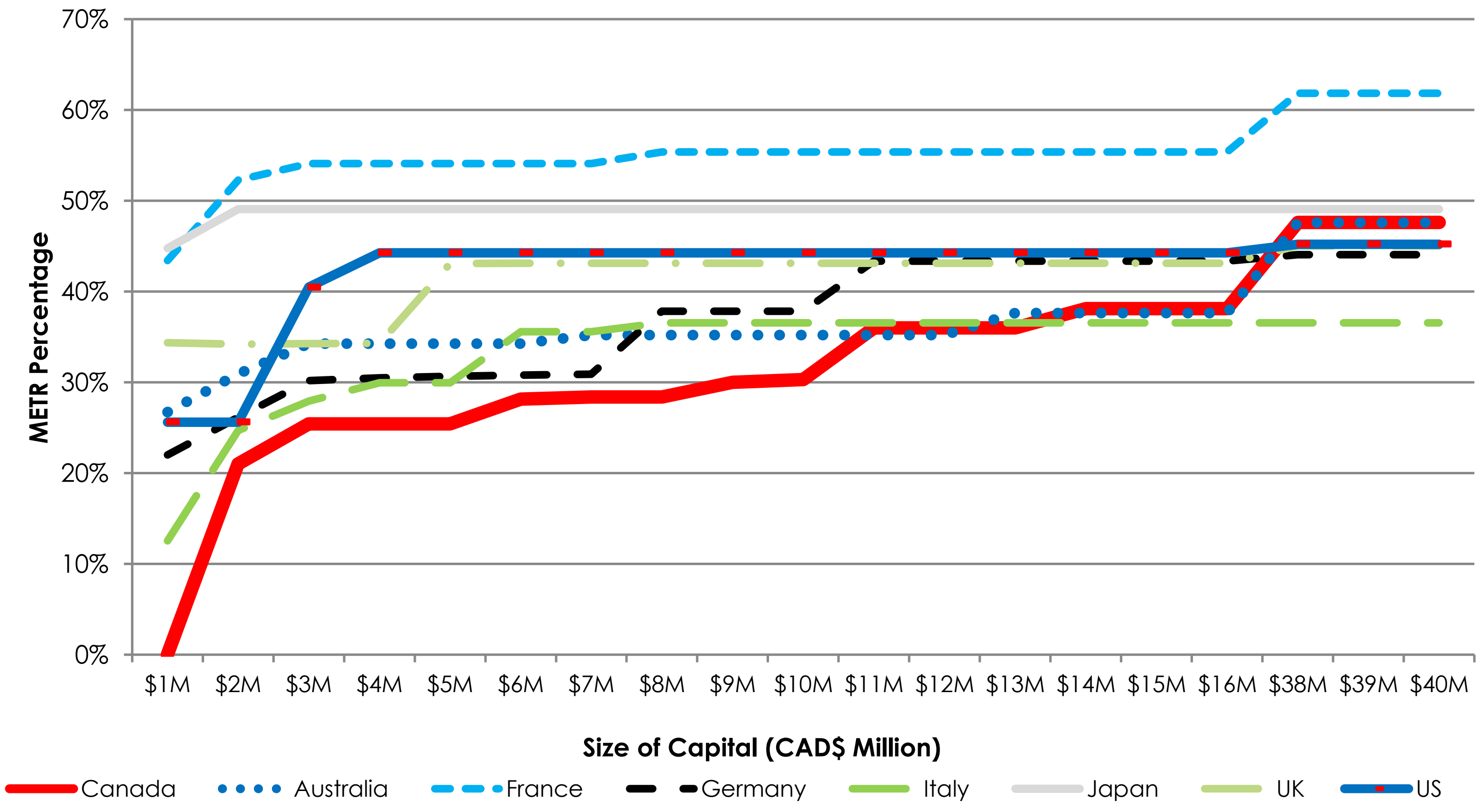
METR for Small Business (Percentage)

METR for Small Business with Increased Debt (Percentage)

Canada is not competitive with the US for start-ups that grow beyond $15 million in asset size



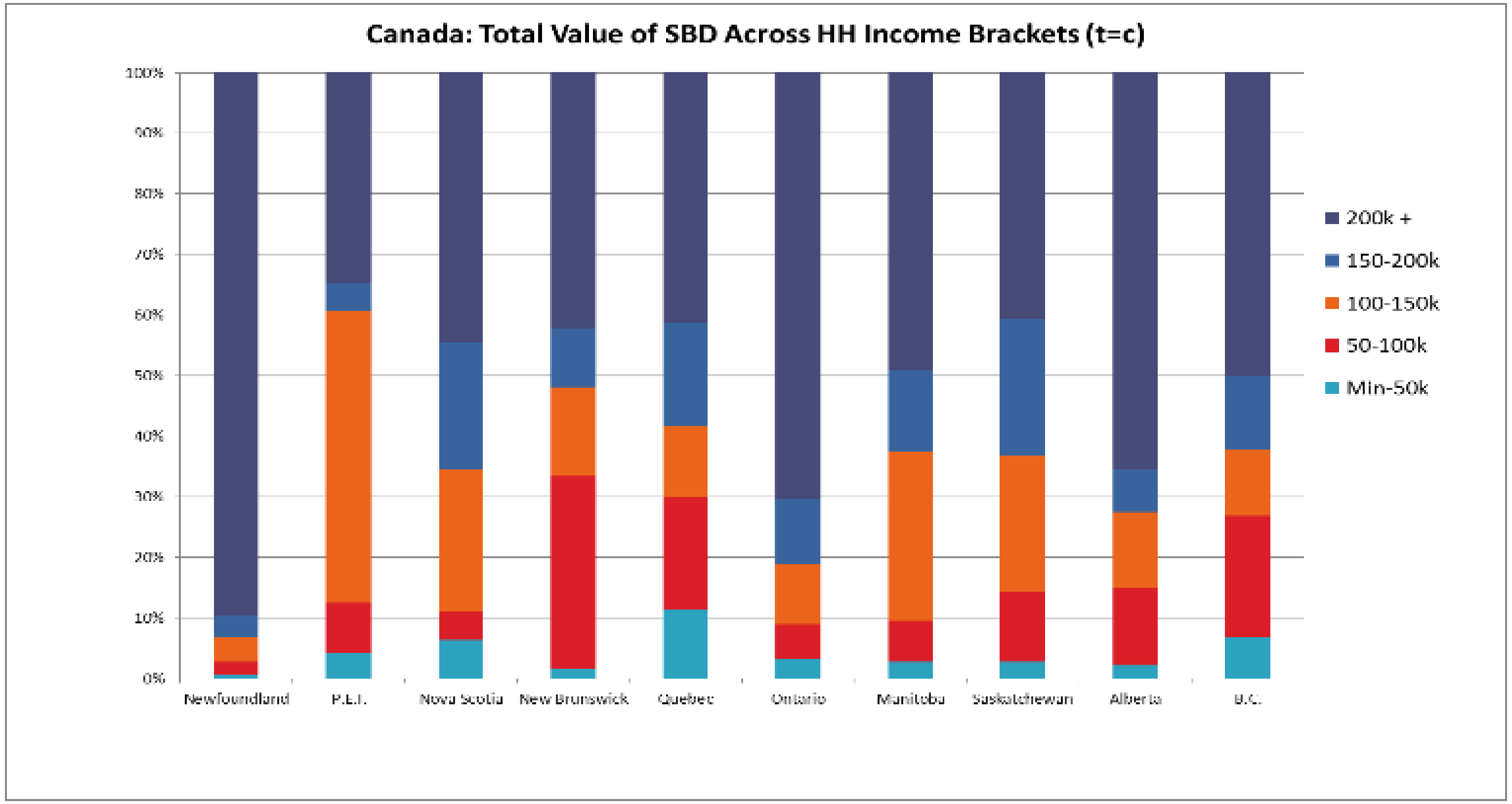
But we are competitive compared to France! (but we have a steep tax wall)



Fairness

- Horizontal equity:
  - Business income is risky compared to salaried income. Tax treatment is not neutral.
  - Families can pay more tax than single individuals
  - Unsheltered investment income, not indexed for inflation, is highly taxed
    - Bond with 3% interest rate, 50% tax rate and 2% inflation provides -0.5% real return to investors (eats up principal).
- Vertical equity
  - Tax benefits of small business deductions and other preferences geared to higher incomes.

Value of small business deduction across income groups



Complexity

- Existing system is complex
- Two corporate income tax rates in each province (small and large and in some provinces special rates for manufacturing and resource companies). Private corporate investment income subject to high rates.
- Two dividend tax rates.
- Capital gains tax rates out of sync with dividend tax rates encouraging tax planning.
- Tax treatment of investment income in a Canadian-controlled company is complex.

July 18th Proposal

- Reduces scope for income splitting.
- Eliminates deferral when retained active business income is reinvested in passive assets. Under one approach, income paid out is subject to a 73% tax rate to claw back differential between top personal marginal tax rate and corporate rate.
- Reduces scope to convert dividends into capital gains with tighter surplus stripping rules (significant impact on inter-generational transfers).

Evaluation of Private Corporation Proposals

- Efficiency:
  - New proposals have little to do with reducing distortions except for choice between unincorporated (self-employed) and incorporated businesses.
  - Creates a new distortion between real capital investment and passive income investments held by a corporation: deferral possible if money invested in real assets but not passive income assets. Could lead to inferior investments.
  - Creates a distortion between public and private corporations, Canadian and non-Canadian private corporations. Creates an issue with respect to family succession.
  - Does not correct limitations on RRSP contributions from dividends (and capital gains).
  - Makes Canada less competitive for start-ups.
  - Does not address the tax wall and complexity with differential corporate rates.
  - Does not keep in mind riskiness of entrepreneurial income and appropriate remedies.
  - Passive income rules will not apply in principle if passive assets are used for business purposes but unclear how this will be applied.
  - Passive income rules result in use of retrospective tax rates that rely on an assumption of constant marginal tax rates and income over time.

Evaluation of Private Corporation Proposals

- Fairness:
  - Vertical equity: balance of measures fall on higher income Canadians more heavily but many middle class entrepreneurs will be affected.
  - Horizontal equity:
    - Reduces scope to avoid (high) personal taxes by incorporating.
    - Aggravates differences between risky and non-risky income.
    - Raises issues regarding the role of family taxation in Canada (family concept used for pension/RRSP income, income-tested benefits and family law).
    - Retroactive taxation related to surplus stripping lead to unfair results for existing estate planning structures (90 percent “estate tax rates” in some cases).

Evaluation of Private Corporation Proposals

- Minimizing compliance and administrative costs
  - Adds to current complexity – does not address sources of complexity in the first place.
  - Will encourage new types of tax planning.
  - Passive income and income rules rely on judgment such as value of family member contribution to business and the degree to which passive assets are used as part of business operations (credit risk, working capital, future expansion, etc).

What would have been better?

- Efficiency, complexity and fairness could be better addressed by more significant reforms to provide incentives for business income.
- Follow UK by moving to one single corporate income tax rate. Eliminates need for two dividend tax credits.
- Even up difference between capital gains taxes on disposals and dividend tax credits as much as possible which makes new surplus stripping rule redundant.
- Provide an election for company to flow income to investors rather than be subject to complex to new rules (e.g. sub-chapter S provision in the United States for small businesses).
- Even better – put in context of a major tax reform – lower rates and neutrality given existing issues related to risk, inflation and double taxation of savings.