How Not to Win Friends and Influence People When Changing Private Corporation Tax Policy

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Taxing Small Corporations: Increasing Fairness or Undermining Growth

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HOW TO WIN FRIENDS & INFLUENCE PEOPLE
The Only Book You Need to Lead You to Success

SPECIAL ANNIVERSARY EDITION

Dale Carnegie

NOT

WHEN CHANGING PRIVATE CORPORATION TAX POLICY

Bungling Tax Policy Changes

THE DEPARTMENT OF FINANCE

OVER 75 YEARS IN PRINT!
Should Canada Look at Tax Reform?

• Absolutely! And some of the proposals contained in the July 18, 2017 material have sound rationale.

• The last significant tax reform / study was the Royal Commission on Taxation (so called “Carter Commission”) which commenced its study in 1964 and released its landmark report and recommendations in 1966.

• Such recommendations, after tremendous debate and study, formed part of the foundation for 1972 tax reform.

• The tax profession has been calling for another “Carter” for many years.

• Many aspects of Canadian tax policy need review and “fixing”.

• It’s interesting, however, that the Carter recommendations have largely stood the test of time. “A buck is a buck is a buck.”
Carter Commission
Recommendations Not Accepted

• Interesting that some of the recommendations that Carter made that were not accepted by our Government seem to be the cause of some of the current concerns by the Department of Finance.
• Examples: income splitting and passive asset accumulation.
• Carter recommended that since the family was the basic economic unity of society that it be the taxing unit. Was not accepted and thus income splitting has been a “cat and mouse” game ever since
• (Is family taxation really out of step around the world…especially when the US has a limited form of family taxation?)
• Carter also recommended full integration of corporate and personal income; for example, recommended that a corporation with a small number of shareholders could elect to be treated as a partnership (similar to the US system).
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• Make a benign announcement in the March 2017 Budget documents that, in hindsight, did not signal much.

• (Many tax people thought that the “consultation” documents would be similar to the testamentary trust consultation where a discussion paper was released and six months was given to provide comments; in hindsight, however, the consultation didn’t appear to accomplish much….despite many submissions received, virtually all of the content in the paper was released into draft legislation 9 months after the consultation period ended on December 2, 2013).

• Release the “consultation document” in the dead of summer…July 18, 2017.

• Not fully consider all of the “unintended” fallout from the draft legislation (this presentation focuses on these implementation issues….aka a ground-floor perspective).

• Make the “consultation” period a brief 75 days that will end when the business community has just started to wake up from the summer doldrums.
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• Release the proposed changes using populist language such as:
  • “But there is a sense that some may be getting a better deal than others.”
  • “And it starts by making sure that we all pay our fair share of taxes – with no exceptions.”
  • “….our Government is taking steps to address tax planning strategies and close loopholes that are only available to some – often the very wealthy or the highest income earners – at the expense of others.
  • “Currently there are signs that our system isn’t working as well as it should, specifically when it comes to private corporations.”
  • Did the Department of Finance really think the business and tax community would accept such accusations?
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• Release the “consultation paper” with draft legislation for 2 of the 3 proposals with effective dates of July 18, 2017 or January 1, 2018 (depending on what specific aspect of the proposals you’re dealing with).
• For the third proposal – passive income / asset – assume the objective is sound and only ask the reader to pick which options would “fairly” meet the objective.
• Defend the proposals at all costs – using social media, television, print media and a “listening tour” - even if the messages that are being stated are misleading and false.
• Keep trumpeting the message that such proposals will only affect a small few – the wealthy – when in reality the proposals reflect the most significant tax policy changes affecting private corporations and their shareholders since 1972 and will impact virtually all private corporations and their shareholders.
How Not to Win Friends and Influence People When Changing Private Corporation Tax Policy – Income Sprinkling

- Extremely vague and complex.  *Spoiler alert – the Joint Commission on this aspect of the proposals will be likely 30+ pages.*
- Not workable in practice.
- Will result in huge increase in litigation.
- Reasonableness test to receive property income?  Show me another jurisdiction that has something similar.
- Does not consider marital property rights that spouses / common-law partners have notwithstanding negligible efforts.
- Family and non-arm’s length “friends” financing will be caught.
- Retroactive taxation effect for utilization of capital gains deduction – “fresh start” rule property held by minors and trusts.
- Lower tax bracket family is hurt by these proposals by a much greater extent than high tax bracket families because the rules impose top marginal rates even if the total income would have been subjected to a lower tax bracket (with no sprinkling).
How Not to Win Friends and Influence People When Changing Private Corporation Tax Policy – s. 84.1 / 246.1 Proposals

• Retroactive effect for non-arm’s length transfers of CCPC shares to another Holdco.
• Family succession planning impacted (acknowledged by Finance but still has a July 18, 2017 effective date).
• Significant problems with post-mortem planning to avoid double taxation.
  – In some cases – when combined with the “income sprinkling” proposals - the effective rate on death can be as high as 93% (if you live in Ontario).
• Section 246.1 – general anti-surplus stripping rule – has retroactive effect in the calculation of the CDA. Wayyyyy too broad.
How Not to Win Friends and Influence People When Changing Private Corporation Tax Policy – Passive Income / Asset

• Equates employee “neighbor” with that of an entrepreneur in the name of “fairness”.
• Spreadsheets that are flawed because they assume top marginal rate - used to display the “fairness” and ignore the behavioral impact that such proposals will have on entrepreneurs.
• 1972 Budget speech has been used as “evidence” that the government intended the low corporate rate to not be used as a method to accumulate passive assets: “If a corporation employs the tax savings that result from the low rate for non-business purposes, such as portfolio investments, a special refundable tax will be imposed to recover the low-rate benefit.”
• However, such refundable tax was retroactively repealed by the Hon. John N. Turner (Minister of Finance – in his 1973 Budget Speech – explained the repeal was due in part to complexity and in part to encourage small business expansion, reinvestment and job creation).
• Wouldn’t the repeal – retroactively – speak to a different view?
• At a minimum, proposals should consider the reasons why entrepreneurs use the lower rate to accumulate passive assets and be sympathetic to some of the reasons?
• New distortions between private and public corporations?
Punitive Impact of Passive Income Proposal to Lower Tax Bracket Taxpayers

- Neutrality only achieved for business owners in the top marginal tax bracket.
- Disproportionately harm business owners in lower marginal tax brackets, since the proposal’s corporate tax on investment income will be a flat 50% tax, higher than the personal tax would have been.
- For example, for a business owner who is normally at the $46 – 74K tax bracket in Ontario, his net after-tax investment return will be 30% less if he invest corporately under the new proposal, versus if he invested personally with after-personal-tax dollars. This is not neutral, this is harmful to middle class business owners.
This leaves smaller businesses 2 choices: a) leave the surplus inside the corporation as uninvested cash; or b) constantly extract surplus.

- Counter to promoting growth for small businesses. Might leave smaller businesses more vulnerable?
Well, Wouldn’t The Rational Business Owner at Lower Rates Simply Pull $$ Out and Invest Personally??

- Many non-tax reasons why corporations want to retain earnings inside corporation: cushioning business cycles, building up surplus for future business expansion/reinvestment, and compensate for the lack of safety nets like sick leave, EI, mat leave etc.
- And just the fact that many business owners will not want to draw funds out and prepay personal tax, if those funds not needed for personal use.
- Yes, dollars can be pulled of corporation and injected into RRSP (assuming contribution exists) but most will likely not due to administrative burden associated with withdrawing RRSPs. Most people would have issues with contributing and then shortly thereafter withdrawing from an RRSP. Easier to simply leave the money in the corporation – either uninvested or invested in a low risk / low rate return that would justify the high tax rate.
- Bottom line, behavioral consequences cannot be illustrated through simple spreadsheet analysis.
So What to Do?

- Slow the process down and do it right.
- Drop the rhetoric - on both sides - for a reasoned discussion.
- Ideally, commence “Carter 2” that would engage ALL stakeholders.
- Enable spouse / common-law sprinkling but expand existing “kiddie tax” to “adultolescents” – such as to age 24….similar to that of the US or bring in family taxation.
- Fix the double taxation problems with post-mortem extractions of assets (perhaps expand subsection 164(6) to a 3 year period and make it elective to deal with post-mortem concerns).
- Fix all other double taxation issues.
- Fix the family succession issues.
So What to Do?

• Completely abandon passive asset / income issues; or, at a minimum, restructure the proposals to enable entrepreneurs to build-up an “acceptable” level of assets.
• Consider repealing SBD; or expand the SIB rules to single employee professional corporations (develop minimum employee thresholds, example 3).
• (Note that pre-1984, professionals that were incorporated were “non-qualifying businesses” which were taxed at an intermediate rate of 33%).
• Enforce existing rules such as the personal services business rules to otherwise incorporated employees, various attribution rules and reasonable salaries.
• Seek to reduce complexity.
Can We All Just Get Along and Get Significant Tax Reform Right?
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