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Comments on Consultation Paper (July 18, 2017) Tax Planning Using Private Corporations

Madam, Sir:

Please find enclosed some comments on the Tax Planning Using Private Corporations consultation paper (dated July 18, 2017).

I consent to the disclosure of my submission in whole.

Regards,

(signed) *François Brouard*

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MEMORANDUM

Comments on Consultation Paper Tax Planning Using Private Corporations

prepared by

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presented to

The Honourable Bill Morneau,
Department of Finance, Government of Canada

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INTRODUCTION

This memorandum includes some comments on the “Tax Planning Using Private Corporations” consultation paper and technical briefing slides (dated July 18, 2017) (thereafter the consultation paper, the proposal or tax measures).

I am a professor in taxation at the university level preparing accounting students and future chartered professional accountants. In the past, I have also worked in taxation for an international accounting firm (see biographical note in Appendix A). I am involved in taxation for more than 30 years. As an educator, I am concerned about the complexity of the tax rules and at the logics and coherence between the various tax rules. As part of my research program, I am interested by tax simplification in a Canadian context.

PRINCIPLES / OBJECTIVES OF TAX POLICY

A few principles / objectives should guide revision of the tax policy and the *Income Tax Act* (ITA), namely:

- equity / fairness
- neutrality
- simplicity
- adequacy
- efficiency
- stability / certainty
- balance between sectors
- flexibility over social and economic goals

Fairness and neutrality are the preferred objectives in the tax measures. However, other tax policy objectives such as simplicity should be integrated in the revision. The simplicity objective is especially important considering literacy, financial literacy and tax literacy.

INCOME SPRINKLING

Income sprinkling vs income splitting

Using the term “income sprinkling” instead of “income splitting” was an appropriate choice to describe a phenomenon. Not all private corporations use income sprinkling tax strategies. My understanding is that income sprinkling (without real contribution by family members) is not acceptable, while income splitting (with real contribution by family members) is acceptable. The contributions by family members could be time / labour or capital. In most cases, it will be time / labour.

Fairness of income splitting with salary or dividend

Under the current ITA, it is possible to have income splitting with salary between family members. Rules are in place to restrict deductions of salary only to reasonable amounts for work performed in the corporations by family members. It is difficult to assess the effectiveness of the reasonableness measure considering the level of tax audits. Considering the known low level of audit, I am not convinced that employment income (without real work – “ghost job”) is not and will not be used for income sprinkling.

Payment of reasonable amounts of dividends (in lieu of salary) for work performed in the corporations by family members should be acceptable. The rules should be similar to the ones for salary on reasonableness.

Unfairness of income sprinkling with dividends

In general, I agree with the proposed measures dealing with income sprinkling with dividends. It is a reform going in the right direction. The fairness principle should be pursued.

Extension of the tax on split income (TOSI) rules

The TOSI rules try to prevent income sprinkling with minors

The TOSI rules need improvement. A clear path should be integrated in the tax rules to make sure that the attribution rules and the TOSI rules are well understood. The implications and objectives of the TOSI rules may be included in the attribution rules.

Meaning of specified individual

The inclusion of all adult specified individual should have a limit in time (ex: 25 years old or 30 years old). What is the age under which an individual is independent from a parent? End of education period? Never?

Reasonableness test – Individuals age 18 and over

Question about the age level (under 25 years old), why not 30 years old? What is the age under which an individual is independent from a parent? End of education period? Never?

In theory, the labour contributions, capital contributions and previous returns / remuneration are interesting. However, it may add complexity in practice. A calculation will be needed to recall how much money is paid to whom and from what. Is the reasonableness test now in the ITA insufficient?

Is it possible for an individual to receive dividends instead of employment income? Apparently not. It should be possible in lieu of salary.

Meaning of connected individual

The concept of connected individual should be replaced by another expression. As the term connected is already used regarding corporations, it will be confusing to use the same term for a different concept. **I suggest the term interconnected individual or interrelated individual instead of connected individual.**

Additional changes to TOSI rules

Would the split income not be better covered under the attribution rules?

Constraining multiplication of claims of the lifetime capital gains exemption (LCGE)

The question of the Lifetime Capital gains exemptions (LCGE) is important in recognizing the investment, risks and sacrifices of entrepreneurs. Multiple members of a family could be allowed to benefit from the LCGE. The multiplication assumed a significant increase in value to be beneficial. It is important to distinguish the transfer of a business to family members and a transfer purely for a tax benefit. The question is to determine if it is a genuine transfer transaction or a tax motivated one.

The transfer of a business to family members is usually done over time, not necessarily in a unique transaction. When a family or genuine intergenerational transfer is on-going, the LCGE should be used by multiple members of a family.

When the transfer is purely for a tax benefit, the LCGE should not be used by multiple members of a family. The General anti-avoidance rules (GAAR) should be used to avoid the multiplication.

Age limits

I agree with the 18 years old limit.

Reasonableness test

More details are needed about the limits on the reasonableness test. The tax system should be as clear as possible to avoid interpretation. On the other hand, is the reasonableness test now in the ITA insufficient? If not, the reasonableness test should also apply to salary.

Trusts

No comments.

Supporting measures to improve the integrity of the tax system

I am not convinced about the reporting requirements applicable only to partnerships and trusts. Why not reporting all the amounts paid to specified individual?

HOLDING PASSIVE INVESTMENTS INSIDE A PRIVATE CORPORATION

The tax measures regarding the holding passive investments inside a private corporation should continue to be examined. The examination should take place in light of a broader reflection of the tax system. More consultation will be needed in the future.

Comparison of options

When comparing options, the comparison should also take into account all the various tax and non-tax factors. Some comparisons opposed entrepreneurs and employees. Among those factors, we could cite for employees: pensions plan, vacations, sick days, medical insurance and other employment benefits and, for the entrepreneurs: flexibility (ex: income splitting, salary-dividend), deductions of 'business' expenses, higher RRSP limits, etc. All of those factors should be considered. A balance is needed to obtain a fair comparison. However, the "income tax system" is based on income. If we need another sets of "?? tax system", it will be a different system that will need to be design, if possible.

The comparison should also distinguish the various types and sources of income.

Concept of integration and integration of dividend and RDTOH

The concept of integration is an important concept in the Canadian tax system. It restores neutrality into the tax system. However, considering the various corporate tax rates at the federal and provincial levels, it is not working at 100% in practice. Depending on the type of income, the province and the provincial dividend tax credit, over or under integration happen in practice. Because of the dividend tax credit, it is possible for an individual to receive dividends without paying any taxes considering the tax credits, including the dividend tax credit. If the concept of integration is considered important, as it should be, the integration should be maintained in all aspects.

The real tax benefit of a CCPC is in leaving passive investment in the corporation to defer tax. If the individual shareholder need the money earned, he will get the funds, leaving no passive investment in the corporation. Most CCPC shareholders (Mom and Pop) probably need most of their funds, leaving application of the rules to a small group of taxpayers.

The following tables provide more details about the concept of integration. The first two figures are more completed than the integration example in the slides (p.8). The integration could work with any tax rate. The third figure provides a synthesis about the integration of dividend and investment income into a CCPC.

2017 Income from Property

Theoretical Taxation of Dividends - 14.5%

	<u>Theory</u>	<u>Corp.</u>	<u>Individ.</u>
<i>Corporation</i>			
– Basic income		\$1,000	
– Corporate tax (theoretical rate)	14.5%	145 *	
– After-tax earnings available for dividends		<u>\$ 855</u>	
<i>Individual Shareholder</i>			
– Basic income (individual)			\$1,000
– Dividend		\$ 855	
– Gross-up (17%)	corp. tax	<u>145</u> *	
– Taxable income	corp. inc.	<u>\$1,000</u>	<u>\$1,000</u>
– Personal tax (theoretical rate)	39%	\$ 390	\$ 390
– Dividend tax credit	corp. tax	(145) *	
– Net tax		<u>\$ 245</u>	<u>\$ 390</u>
Total taxes paid		\$390	\$390

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2017 Income from Property

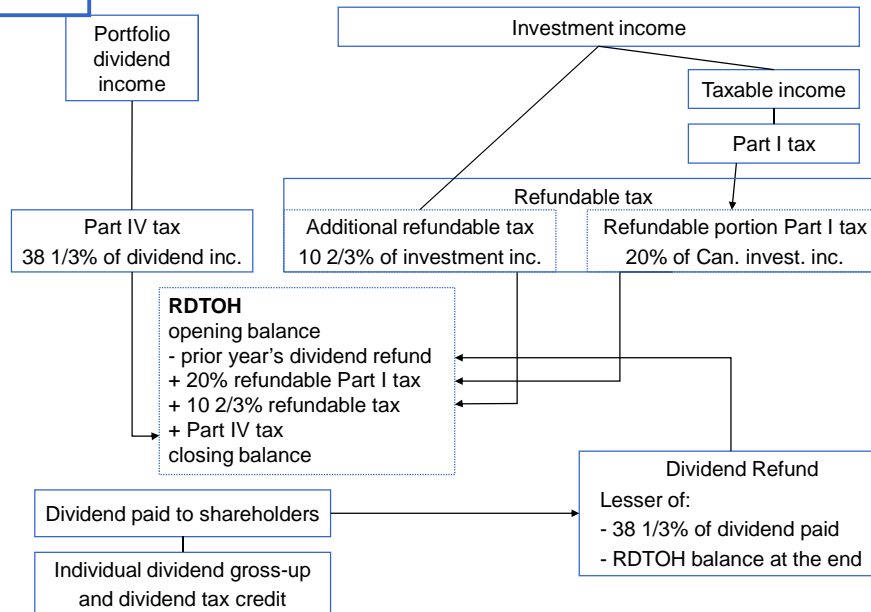
Theoretical Taxation of Dividends - 27.5%

	<u>Theory</u>	<u>Corp.</u>	<u>Individ.</u>
<i>Corporation</i>			
– Basic income		\$1,000	
– Corporate tax (theoretical rate)	27.5%	275 *	
– After-tax earnings available for dividends		<u>\$ 725</u>	
<i>Individual Shareholder</i>			
– Basic income (individual)			\$1,000
– Dividend		\$ 725	
– Gross-up (38%)	corp. tax	<u>275</u> *	
– Taxable income	corp. inc.	<u>\$1,000</u>	<u>\$1,000</u>
– Personal tax (theoretical rate)	39%	\$ 390	\$ 390
– Dividend tax credit	corp. tax	(275) *	
– Net tax		<u>\$ 115</u>	<u>\$ 390</u>
Total taxes paid		\$390	\$390

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2017

Integration of Dividend and Investment Income CCPC



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Approach 1: The 1972 approach

It is surprising to design a tax system and to retroactively repeal shortly after its implementation. Implementation is as important as design. Which argument is more important: the complex and difficult or the fairness?

Approach 2: Deferred taxation

2a) Deferred taxation – Apportionment method

The apportionment method is preferable. At least, the apportionment method achieves neutrality equal net worth amounts under the individual and corporation route (tables 7, 8, and 9). The calculation of the three pools is not too complicated, is understandable and is clear in its application.

2b) Deferred taxation – Elective method

The elective method doesn't achieve neutrality as net worth amounts under the individual and default treatment route are different (table 10). The method also adds to the complexity.

Approach 3: Further election

By allowing an additional election, it adds complexity to the tax system. It is unnecessary.

Approach 4: Election of CCPC being treated like a public corporation

Maybe a possible option could be to allow CCPC to adopt the public or non-CCPC corporation tax treatment. However, this may add complexity. Another option could be to eliminate small business deduction for CCPC. However, taxpayers could not get the small business deduction and other benefits of a CCPC without the negative consequences.

Simplicity for smaller businesses and transition

As the passive investment income is probably in the hands of a small number of high earners (data needed), it would be important to limit the application of the complexities of those organizations. Mom and pop businesses should be exempted from those complex rules. For example, passive investments rules could apply only over a threshold level of investment, total assets and/or income (ex: similar to the small business deduction or to Part VII tax in capital of financial institutions). The threshold amounts need to be determined.

Transitional rules should be in place to achieve simplicity and fairness.

Need to define passive income

Even if the ITA is not too keen on some definitions (ex: definition of “income” in ITA?), it would be a good idea to develop a clear and simple definition of “passive income”.

CONVERTING INCOME INTO CAPITAL GAINS

The conversion of income into capital (surplus stripping – ITA 84.1) or conversion of capital (gains stripping – ITA 55(2)) are complex tax provisions.

Intergenerational business transfer

I agree that distinction between genuine intergenerational transfer and tax avoidance transaction is major policy concern. Genuine intergenerational business transfer should be allowed and encouraged.

Section 84.1

ITA section 84.1 should be revised to be easier to understand (more pedagogical, if possible) and to allow the genuine intergenerational business transfer.

TAX SIMPLIFICATION AND GLOBAL TAX REFORM

Over the years, the Canadian tax system has become more and more complex. A lot of individual groups have benefit from various deductions or tax credits. Those tax benefits have eroded the collection of taxes. The effort to eliminate some boutique tax credits in recent budget is a good step forward. However, a stronger effort about tax simplification should be pursue. Therefore, **tax simplification is recommended**.

An overall global tax reform of the Canadian tax system is recommended. A global tax reform will allowed questioning the advantages already given to various groups and will allowed integrating multiple changes in a global perspective instead of a piece-meal approach. The concept of tax expenditures should be used to decide again (or not) which tax expenditures (deduction, tax credit) has value to achieve social and economic goals.

A number of examples are provided:

- Is it fair to have a capital gain exemption on the principal residence for a huge capital gain (huge amount to be defined)?
- A lot of the tax measures aim to prevent transfer of income (100%) into capital gains (50%). By including 100% of the capital gains (instead of 50%), some anti-avoidance measures will become useless.
- By integrating major changes, such as inclusion of capital at 100%, will require a global analysis and introduction of new measures, such as a global capital gain exemption (including the measures regarding principal residence (unlimited), qualifying shares of small business corporation (SBC) (\$835,716 in 2017), farm property (\$1,000,000 in 2017)). It may be cap at a lifetime amount.
- Considering the analysis of family tax return in addition or replacing individual tax return. The family could become the tax unit. I am not convinced about this option, but it could also help to solve income sprinkling.
- Elimination of the manufacturing and processing profits deduction (mostly covered by general tax reduction of 13%).
- Employee stock options preferential tax treatment.
- Etc.

REACTIONS TO SOME COMMENTS ON THE PROPOSAL

A number of comments appeared in the media following the proposal. Here are some comments on a number of them.

Competitive business environment

As indicated in the introduction of the consultation paper (charts 1 and 2), the corporate taxes in Canada is highly competitive.

Tax loopholes

The concept of tax loophole (échappatoire fiscale) could be defined¹ as a «lacune ou ambiguïté du libellé d'une loi fiscale qui offre au contribuable la possibilité d'éviter ou de réduire un impôt». There is nothing in the definition of loophole to presume a criminal activity as some comments assumed ("tax cheats" was used by opponents). Various tax strategies are perfectly legal at the moment. However, a better communication and education is probably needed regarding the tax system. The intentions of some policy may be examined to determine if it is ambiguity or intentional. Sometimes, it is only for political reasons ...

End of the world or catastrophising ...

Income sprinkling is not a reward for innovation, growth or other stuff.

I share the opinion of Andrew Coyne² on the so-called "critics" from those affected and on equity.

Rewards for entrepreneurs

Entrepreneurs in different domains (technology, service) and at the different stages (startups, growth, mature, decline) should be encouraged. Some tax measures are already in place (ex: SR&ED, small business deduction), but society would benefit from a global examination of all the tax incentives and other incentives to verify achievement of policy goals. Is it enough? Is it too much?

¹ Ménard, L. et al. (2004). *Dictionnaire de la comptabilité et de la gestion financière*, 2e édition, Institut Canadien des Comptables Agréés; Ordre des Experts-Comptables – France; Compagnie Nationale des Commissaires aux comptes – France; Institut des Reviseurs d'Entreprises - Belgique. (Il existe aussi une version plus récente.) (p.1173)

² Coyne, A. (2017, August 19). How to close the tax loopholes – Critics of crackdown on sheltering tricks have forgotten idea of horizontal equity, *The Ottawa Citizen*, p.C6.

Retirement of entrepreneurs and all taxpayers

Registered Retirement Savings Plan (RRSP), Registered Pension Plan (RPP), Registered Retirement Income Funds (RRIF) and Tax-Free Savings Accounts (TFSA) are possible tax planning tools to plan for retirement. Are the actual limits sufficient? Are all the deferred plans available to every taxpayer? A possible revision of the retirement options may be needed for all taxpayers, with a special attention to self-employed entrepreneurs and shareholders of small private corporations. If the passive investment in CCPC is for retirement, let's limit those to the same limit as the other retirement existing plans.

Gender issues

I am not convinced about the specific gender issues of the tax measures. The data to understand the reasons why we are in the present situation of having a gender imbalance need to be found and analyze. With the change in demographics, some of those trends will probably diminish over time.

Lobbying intensity

As expected, tax measures will impact high earners more and therefore will receive a lot of attention from them. The number of submission by high earners, as individuals or groups and their advisors (accounting firms, law firms), will be higher than those from the middle class not affected by the tax measures. Andrew Coyne³ distinguishes two main groups: the experts and the vocal. However, the principles should have priority.

Medical doctors, farmers and other groups

Revision of a tax measure without a global examination of its implications may bring bad tax outcomes. The tax treatment for some groups should be reviewed.

For example, my understanding⁴ is that as part of the negotiation with medical doctors by some provincial governments, the tax measures were part of the total package to obtain a net amount after-tax. Therefore, changing the rules of the game may bring a new negotiation involving the federal and the provincial levels. Again, it is a question of fairness for every stakeholder. In term of principles, the incorporation solution may not have been the

³ Coyne, A. (2017, September 9). It's why they call it income tax, *The Ottawa Citizen*, p.NP3.

⁴ Reevely, D. (2017, July 25). Bid to end 'income sprinkling' draws ire of Ontario doctors, *The Ottawa Citizen*, p.A1.; Platt, B. (2017, September 15). Doctors may take tax change out on provinces – Incorporation usually a factor in setting rates, *The Ottawa Citizen*, p.NP4.

best solution at the time (15-20 years ago). We should come back at the core reasons why incorporation should take place and at the employee – self-employed relationship.

Farms are a special case of intergenerational business transfer and business operations. It is already recognized by the higher lifetime capital gain exemption of \$1,000,000. Retirement of farmers should be integrated in the equation. A special attention and care should be noted for that group. Please consider to support genuine family transfer of a farm and their specific needs and circumstances. For operations, family members may be involved in informal ways. Reasonableness tests should be simple and clear for most farms. Retirement funds for a farmer are often found in the value of its business. Children may not have the cash to pay for the business and the assets. Rental income for farm may be an exception to accommodate this situation.

APPENDIX A: BIOGRAPHICAL NOTE / NOTICE BIOGRAPHIQUE

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François Brouard is a bilingual Chartered Accountant and Chartered Professional Accountant with a bachelor's degree in business administration (B.A.A.) from HEC Montréal, a master's degree in accounting (M.Sc.) from Université du Québec à Montréal (UQAM) and a Doctorate in Business Administration (DBA) from Université du Québec à Trois-Rivières (UQTR). He is currently a Professor in the accounting group (taxation and accounting) at the Sprott School of Business, Carleton University and Founding Director of the Sprott Centre for Social Enterprises (SCSE). In 2012, the Ordre des comptables agréés du Québec (OCAQ) awarded him its highest honour, the title of Fellow Chartered Accountant, followed by the title Fellow Chartered Professional Accountant. Between 2009 and 2015, he was the founding co-editor in chief of ANSERJ - Canadian journal of nonprofit and social economy research / Revue canadienne de recherche sur les OSBL et l'économie sociale. He previously worked as a consultant in training and strategic scanning, a professor at Université du Québec à Hull (UQAH), a project manager for the Professional Education Program of the OCAQ and a lecturer in several universities. He also worked in auditing and tax for an international CA firm (Samson Bélair / Deloitte & Touche). His research interests include social enterprises, social entrepreneurship, financial management, governance, foundations, nonprofits, strategic intelligence, SME, tax, business transfer, accounting profession, and financial planning.

Comptable Agréé et Comptable Professionnel Agréé bilingue, François Brouard détient un baccalauréat en administration des affaires (B.A.A.) de HEC Montréal, une maîtrise en sciences comptables (M.Sc.) de l'Université du Québec à Montréal (UQAM) et un doctorat en administration (DBA) de l'Université du Québec à Trois-Rivières (UQTR). Il est présentement professeur titulaire en fiscalité et comptabilité à la Sprott School of Business, Université Carleton et directeur fondateur du Centre Sprott pour les entreprises sociales (CSES). En 2012, l'Ordre des comptables agréés du Québec (OCAQ) lui a remis sa plus haute distinction, le titre de Fellow Comptable Agréé et par la suite Fellow Comptable Professionnel Agréé. Entre 2009 et 2015, il fut le co-rédacteur en chef fondateur de ANSERJ - Canadian journal of nonprofit and social economy research / Revue canadienne de recherche sur les OSBL et l'économie sociale. Il travaillait auparavant à titre de consultant en formation et veille stratégique, de professeur à l'Université du Québec à Hull (UQAH), de chargé de projet pour le Programme de formation professionnelle de l'OCAQ et de chargé de cours dans plusieurs universités. Il a aussi exercé en vérification et en fiscalité pour une firme internationale de CA (Samson Bélair / Deloitte & Touche). Ses intérêts de recherche sont les entreprises sociales, l'entrepreneuriat social, la gestion financière, la gouvernance, les fondations, les organismes sans but lucratif, la veille stratégique, les PME, la fiscalité, la transmission d'entreprises, la profession comptable et la planification financière.