The Chamber of Commerce
of Metropolitan Montreal

Tax Reform: Reducing the Risk for Our SMEs

Recommendations submitted by the Chamber of Commerce of Metropolitan Montreal to the Ministry of Finance of Canada

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Preface

The Chamber of Commerce of Metropolitan Montreal (the Chamber) has over 7,000 members. Its mission is to act as the voice of Montréal's business community and to promote the prosperity of the city and its businesses. The Chamber is involved in key areas of economic development, advocating a philosophy of action based on engagement, credibility, proactivity, collaboration, and innovation. The Chamber also offers a range of specialized services to individuals and to businesses of all sizes to support their growth both domestically and internationally.

Background

On July 18, 2017, the Minister of Finance of Canada, the Honourable Bill Morneau, introduced draft legislation for federal tax reform. The measures proposed in this legislation include raising taxes in connection with income sprinkling, passive investments inside private corporations, and conversion of business income into capital gains. This brief presents the Chamber's recommendations. The Chamber wishes to thank the committee of experts who contributed to the work and deliberations that went into producing this brief[1].

Introduction

In the budget that it tabled in March 2017, the Government of Canada announced its intention to revise certain provisions of the federal tax system. The purpose of the changes would be to put an end to the opportunities for tax avoidance that some business owners are able to take advantage of under the current system. Thus, in summer 2017, the Minister of Finance of Canada tabled proposed tax reform legislation whose objective is to improve the fairness of Canada's tax system by closing tax loopholes and addressing tax planning strategies that afford unfair advantages.

The Chamber considers it laudable that the federal government is seeking to achieve, through this reform, fairness in the taxes paid by Canadian taxpayers. We strongly support the government's desire to thus foster entrepreneurship and risk-taking and to encourage businesses to invest so as to increase their productivity.

We therefore find the proposed reforms highly perplexing. We believe that these reforms have been poorly calibrated and pose the risk of having harmful effects on investment in SMEs as well as on the growth and transfer of businesses.

Moreover, the proposed measures will further increase the tax burden on Canadians, and especially on business owners, who create wealth and jobs. It should be remembered that our rate of taxation is already one of the highest in North America. If the objective is to ensure that business owners and individuals pay the same tax rate, then ***the government should reduce the tax burden on individuals rather than increase the tax burden on business owners***.

In short, the Chamber recognizes the legitimacy of the objectives that the government has set. But we believe that the planned reforms as proposed by the Minister of Finance miss their target and will have to be modified substantially to prevent their causing too much harm to Canadian businesses.

[1] Members of the committee of experts consulted by the Chamber: Stéphane Leblanc, EY; Paul Ryan, Ravinsky Ryan Lemoine; Caroline Charest, KPMG; Luc Vallée, Laurentian Bank; Guillaume Dubreuil, Canadian Chamber of Commerce.

1. Preserving Canadian competitiveness

The reforms must not undermine investment by and growth of Canadian SMEs

The government proposes to modify the taxation of passive investment income of private corporations. The government believes that business owners benefit from a system that results in unfair treatment in their favour. It wants owners of small businesses to pay essentially the same total income tax as individuals. To reduce the current gap, the proposed reforms present various approaches applicable in the case of distribution of dividends to shareholders:

(1) the introduction of an additional tax on the investment income of private corporations;
(2) a requirement for businesses to pay a temporary tax if they distribute dividends to shareholders.

In the form that these options have been presented, they would limit the ability of Canadian business owners to accumulate budgetary reserves that they might eventually need for such purposes as making acquisitions, investing in other businesses that they own, or surviving economic slowdowns. In short, there are many situations in which setting aside a capital reserve is justified.

Many members of the business community have expressed their concerns about the impact of the proposed changes on their ability to expand and invest. For example, in the technology sector, some[2]say that these changes would compromise the federal government's efforts[3] to stimulate innovation in Canada.

These options therefore represent a threat to SMEs' ability to invest. In the Chamber's opinion, the government should instead implement measures ensuring the predictability and stability of the tax system so as to support private investment and enable business owners to make informed, rational choices on the basis of future opportunities and future risks. Businesses' decisions to invest, to hire and to build inventories depend in large part on the information made available to them and on their business environment. In this regard, uncertainty regarding taxation or any other issue interferes with decision-making and can only delay the making of significant investments.

Recommendation 1: Perform a much more rigorous evaluation of the possible scenarios for holding passive investments and ensure that the reforms preserve SMEs' ability to invest and to maintain adequate reserves to cope with economic uncertainties.

The reforms must not add to the already heavy tax burden in Canada.

A more effective and efficient tax system can support private investment, enhance productivity and competitiveness, encourage work and attract talent. It can serve as a crucial lever for the economy in the current context of slow growth and an aging population. But the more onerous the tax system, the less SMEs will be able to accumulate the funds needed for their future growth.

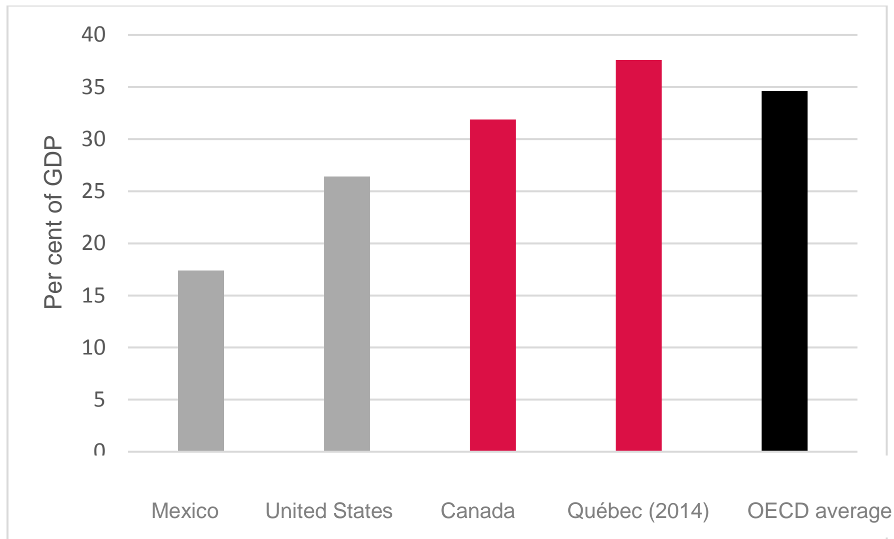
The individual tax rate in Canada is already one of the highest in North America. As things stand now, the tax burden on private corporations and small businesses in Canada remains one of the most competitive among all OECD countries. However, SME owners and individuals pay more income tax in Canada than anywhere else in North America. The situation is even more striking in Québec, where the tax ratio[4] as of 2014 was three percentage points higher than the OECD average. Moreover, as a result of the Government

[2] "Tech CEOs warn tax changes threaten startups' innovation", *The Globe and Mail,* September 12, 2017.
[3] In its last budget, tabled in March 2017, the Government of Canada announced an ambitious innovation and skills plan whose objective is to double the number of businesses in the digital technology, clean technology and health technology sectors by 2025.

[4] The tax ratio is the ratio of total tax revenues collected to gross domestic product (GDP). It measures the proportion of the national wealth collected in taxes and indicates the extent of the taxation burden in a given jurisdiction.

of Canada's first budget, the combined marginal tax rate for individuals in the highest income bracket exceeded 50% in Québec.

Table 1: Tax ratios in North America compared with the OECD average in 2015



Source: OECD, compiled by CCMM

These high tax rates have an impact on the disposable income of middle-class wage earners and SME owners. Unlike wage earners, owners of family businesses pay income tax twice: first on their income and second after having invested it and paid tax on the return.

As regards the introduction of an additional tax on the passive investment income of corporations, one of the conceivable possibilities is that in Québec, the cumulative effective tax rate, after distribution to shareholders, would be as much as 72% on interest income and 58% on capital gains.

The business community is especially concerned about the risk that Canada will become less competitive vis-à-vis the United States in terms of total taxation. In this regard, the major tax cuts proposed by the Trump administration create a new situation that will have immediate consequences for the competitive position of the Canadian tax system.

If our tax system becomes substantially more burdensome for SMEs, it will have a direct impact on decisions to start new businesses and expand existing ones. Thousands of well paid, high-quality jobs for middle-class workers, as well as the economic and fiscal benefits for the various levels of government, will also be compromised. Canada has no choice but to maintain a competitive tax regime for SMEs.

The economic indicators for Canada are favourable. Economists are even revising their GDP growth forecasts for 2017 upward, to 3%. The labour market is in good shape too. Over 200,000 full-time jobs have been created in the past 10 months – the best record in a decade. Consumer confidence is at its highest point since the recession of 2008. At a time when the Canadian economy is regaining its strength, the Chamber is asking the federal government not to slow this momentum but instead to opt for a long-term plan that reduces the tax burden on Canadians and on SMEs.

Recommendation 2: Take the time to examine the U.S. tax reform and to assess its possible implications before finalizing and applying the Canadian tax reforms.

Recommendation 3: Gradually reduce the tax burden on individuals.

2. Maintain a competitive, clear, simple, predictable tax environment

The vast majority of Québec's economic fabric is composed of SMEs. These businesses must invest, innovate, grow, and make decisions that are difficult and often risky. To act effectively, they need a tax environment that is competitive, clear, simple and predictable.

Reduce complexity and uncertainty in the tax environment

Some of the proposed reforms will create complexity and uncertainty for business owners and their families. This is especially so of the new, ill-defined criteria for "reasonableness" that business owners and members of their families would have to satisfy to benefit from certain exemptions, as well as of certain measures surrounding the conversion of a private corporation's regular income into capital gains.

Uncertainty generated by "reasonableness"

This proposal has a broad impact and adds to complexity, in particular concerning the sprinkling of income among the members of a family who own shares in the same business. In particular, broadening the criterion of *reasonableness* so as to include children age 18 and over complicates the administrative determination and entails subjectivity.

Under the proposed rules, the child of a business owner will have to demonstrate that he or she has contributed considerably to the business's activities, or else pay the highest tax rate. In order to evaluate the application of the new tax provisions regarding split income, it will therefore be necessary to determine the contributions of capital or labour that a "related individual" (family member) has made to a private corporation[5].

The production of the evidence required to demonstrate the "reasonableness" of the contribution will thus be tedious and complex, both for the business owners and for the public servants who will have to administer these provisions. It will be up to the courts to determine how this concept applies in this new context. While waiting for the courts to establish jurisprudence, many business owners will be left in uncertainty, which will create a climate less conducive to investment.

Moreover, the proposed measures fail to consider the seasonality of certain workers in sectors such as tourism and agriculture. These workers often work intermittently and part-time, which makes it hard for them to have been actively engaged in the business continuously.

The Minister of Finance has in fact stated that the reforms would not apply to the agriculture sector. That said, the departmental documents do not mention this, and as we have just stated, the agriculture sector is not the only one that is characterized by seasonality and part-time work.

The proposals regarding income sprinkling will have collateral effects on the incomes of many families. According to the Canadian Federation of Independent Business, 70% of its members employ members[6] of their families. We must therefore not take this situation lightly.

Lastly, the application of the criterion of "reasonableness" to the lifetime capital gains exemption and to part-time seasonal work will also have repercussions on intergenerational sales and transfers. We will return to this specific question later in this brief.

Recommendation 4: Clarify the scope of "reasonableness" to reduce the uncertainty that it entails.

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[5] EY, "Private company insights: federal tax reform", *Tax Alert – Canada*, Issue No. 33, July 2017.

[6] "Les PME s'inquiètent du projet de réforme fiscal au fédéral", *La Presse*, July 2017. (Online: http://www.lapresse.ca/la-voix-de-lest/opinions/courrier-des-lecteurs/201707/19/01-5117629-les-pme-sinquietent-du-projet-de-reforme-fiscale-du-federal.php)

Recommendation 5: Include the exception for agriculture in the official documents and extend it to other seasonal sectors such as tourism.

Converting a corporation's regular income into capital gains[7]

The anti-avoidance rules apply to the conversion of a corporation's regular income into capital gains. Under the current measures, anti-avoidance rules are already in place to prevent an individual from selling the shares of one private corporation to another, related corporation.

The capital gain is redefined as a dividend. With the proposed measures, the government intends:

(1) to extend this anti-avoidance rule to prohibit the use of the tax cost on the shares of the said corporation;

(2) to introduce a new anti-avoidance rule to redefine a capital dividend or any form of non-taxable distribution as a taxable dividend.

According to several experts whom the Chamber has consulted, the new rules are ill suited to deal with certain less conventional situations and in some cases could event result in double taxation upon death.

Moreover, these measures do not specify the cases in which these rules would apply. Their scope of application therefore remains vague, broad and ambiguous. These measures will thus create uncertainty about the tax consequences of practically any business transaction by a private corporation. Even a routine transaction, such as the saving of an incorporated duplex owner, could be targeted by this rule, as well as any disposition of an asset of a corporation from which the shareholder has planned to withdraw the proceeds of the sale. Let's take the example of a corporation that owns a building. The corporation sells this building to a third party, and the shareholder intends to pay himself a dividend once he has received the proceeds of the sale. The new measures will affect this kind of transaction, even if there is no avoidance.

The Chamber recommends that the government simplify its proposals and take steps so that they address anti-avoidance situations only. The tax system must be simple, transparent and easy to understand and administer.

Recommendation 6: Alleviate the uncertainty surrounding the third section of the proposed reforms by supporting and simplifying the government's proposal.

In the Chamber's opinion, a tax system that is complex and hard to understand generates costs for the government as well as for individuals and businesses, and especially SMEs[8], which represent over 99% of all businesses in Canada and the majority of which are located in Québec and Ontario.

One of the tests that the government should impose on itself for evaluating its reforms should be whether it reduces SMEs' costs of complying with the requirements of the tax system. To do so, it is essential to simplify the tax measures.

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[7] Section D of the document tabled by the Minister of Finance of Canada.

[8] According to Industry Canada, as of December 2015, Canada had 1.17 million businesses with employees, of which 1.14 million (97.9%) were small businesses, 21,415 (1.8 %) were medium-sized businesses, and 2,933 (0.3 %) were large businesses.

The government has already announced that the measures related to the conversion of a corporation's regular income into capital gains would take effect on July 18, 2017 and would be retroactive. Some cases currently being processed are directly affected by these measures, but it will not be possible to wait to see how the courts will interpret the application of the new proposals. These measures will undermine the retention of businesses and the attractiveness of our business environment.

Correct the distortions by adopting a simpler measure

The proposed measures regarding the conversion of regular income into capital gains are designed to prevent certain business owners from applying a strategy to take advantage of the lower rate at which capital gains are taxed compared with the rate applied to dividends, in order to avoid paying the tax. If some business owners currently find this strategy advantageous, it is because the difference between these two rates has increased gradually over the years. For example, as of January 1, 2000, this difference was 3%; now it is 17%.

The government thus now finds itself in a situation where it wants to introduce a reform intended to correct the perverse effects of past political decisions.

In the Chamber's opinion, there is a simpler way than the proposed one to avoid the behaviours that the government wishes to proscribe. Gradually bringing the two rates closer together would make it less profitable for business owners to convert their income into capital gains. In addition, it would avoid the creation of grey areas and the uncertainty resulting from the reforms.

The lack of precision and the ambiguity in the application of these rules will increase the uncertainty. In addition, the retroactivity of the new measures could make business owners mistrust the government and hence could hamper investment.

Recommendation 7: Ensure that the reform measures do not have any retroactive effects.

Reduce the risks for the transfer of family SMEs

Under current tax provisions, business owners can obtain tax exemptions for their children under age 18 on gains placed in a trust. With the proposed measures, the new rules will limit access to the lifetime capital gains exemption.

In Québec, the aging of the population and the lack of succession for businesses are already threatening not only jobs but also the economic vitality of entire regions. According to a study that the Chamber has conducted on the transfer of businesses to new owners[9], about 40% of business owners age 65 and over plan to close their businesses when they retire, because of a lack of successors or potential buyers. As a result, between 5,700 and 10,000 businesses in Québec face the threat of closing within the next seven years.

Moreover, other proposals included in the reforms will reduce the amounts that children have on hand with which to buy their parents' businesses, for example, by making these children pay the highest marginal tax rate after the transfer of the family business if they have not been actively involved in it.

[9] Chamber of Commerce of Metropolitan Montreal, *Transferring businesses to the succession: a major issue for the Québec economy and the sustainability of SMEs*, Montréal, 2014.

As we have mentioned before, in the case of the changes proposed in connection with the conversion of regular income into capital gains, if the owner dies, the shares in the business might have to be sold to outside interests, for economic reasons.

The current rules already prevent parents from taking advantage of the lifetime capital gains exemption when they sell their corporations to their children. With these new measures, it will not be possible to take advantage of a tax cost if a child has purchased the parent's shares, even if he or she is taxed.

These new measures may thus impede the transfer of businesses. Whereas Canadian SMEs need the processes to be simplified, the proposed reforms will compromise the growth of these businesses and the prospects for their being transferred.

Recommendation 8: Eliminate the measures that impede the transfer of family businesses.

Conclusion

The government's objective of eliminating the tax loopholes that the wealthiest taxpayers take advantage of is laudable, and the Chamber is convinced that the proposed reforms will not cause SMEs any undue harm. Some of the measures in the proposed reforms could be adopted rapidly, after some minor modifications had been made in them – for example, the multiple capital gains exemption, the anti-avoidance rules to counter the conversion of dividend income into capital gains, and the establishment of clear rules for splitting income with family members. Others of the measures, however, will require a more in-depth evaluation, because in their current form, they would have negative impacts on our SMEs.

The tax burden in Canada is already the highest in North America. That is why the Chamber recommends that the government lower payroll taxes as well as individual and corporate income taxes.

In the current context, in which the United States is preparing a tax reform that is intended to considerably reduce the taxes levied on businesses, and in which the Government of Canada has announced its intention not to impose a tax on Netflix and the other giants of e-commerce, it seems anachronistic for Canada to be proposing tax reforms that will hurt Canadian SMEs.

The Chamber supports the objectives of the reforms, but is of the opinion that they must be finely calibrated so that they do not have perverse effects and so that they do provide Canadian businesses with a business environment that is flexible, simple, predictable, competitive and fair.

Summary of recommendations

Recommendation 1: Perform a much more rigorous evaluation of the possible scenarios for holding passive investments and ensure that the reforms preserve SMEs' ability to invest and to maintain adequate reserves to cope with economic uncertainties.

Recommendation 2: Take the time to examine the U.S. tax reform and to assess its possible implications before finalizing and applying the Canadian tax reforms.

Recommendation 3: Gradually reduce the tax burden on individuals.

Recommendation 4: Clarify the scope of "reasonableness" to reduce the uncertainty that it entails.

Recommendation 5: Include the exception for agriculture in the official documents and extend it to other seasonal sectors such as tourism.

Recommendation 6: Alleviate the uncertainty surrounding the third section of the proposed reforms by supporting and simplifying the government's proposal.

Recommendation 7: Ensure that the reform measures do not have any retroactive effects.

Recommendation 8: Eliminate the measures that impede the transfer of family businesses.