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July 18, 2017: the Economics of Starting or Growing a Family Business in Canada Just Got a Lot Worse

New Tax Proposals will Result in Significant Harm to the Economy

On July 18, 2017 the Liberal Government released a "Discussion Paper" and related "draft" tax legislative proposals ("Proposals") which will fundamentally change (and dramatically increase) the taxation of family business corporations in Canada.

Under the cloak of "fairness" (as defined by the Government), the undercurrent of this legislation and the accompanying "Discussion Paper" is anything but fair, and is hostile in its tone and effect in an unprecedented manner.

What will be the results of the Proposals?

Here will be the results of the Proposals:

1. The Proposals will make the economics of starting or growing a family business in Canada much less attractive. (The statement that Canada is "open" for business is becoming increasingly meaningless and disingenuous, especially for family businesses.)

2. The Proposals will lead to employee lay-offs in Canada and family business owners exploring opportunities to invest and grow employment outside of Canada.

3. The Proposals if enacted, along with other significant tax increases, will make us uncompetitive vis-a-vis other jurisdictions for individuals and families to start and grow family businesses, including the United States with upcoming tax reforms.

Are these the results the Government intend the Proposals to accomplish?

Proposals are Hostile in both Tone and Effect

The Proposals are (i) incredibly complex, (ii) will not be properly understood by either business owners or their general accounting advisors, and (iii) will require the cost and expense of tax specialists (which may or may not be affordable for family business owners) in order to try to navigate through numerous snares and traps embedded in the Proposals which will result in ridiculous tax rates well in excess of 50% and double taxation.

Why are the Proposals so Hostile?

In my view, the Proposals manifest personal biases of unaccountable Government bureaucrats at the Department of Finance who are tasked by the Government to draft their legislative priorities.

In drafting the Proposals, these Bureaucrats made deliberate choices to adopt harsh approaches to legislate these priorities with retroactive effects (i.e., rewrite the tax implications for historical transactions), over the top resultant tax rates, and double tax traps. Why did these unaccountable Government bureaucrats make those deliberate, over-the-top drafting choices?

Were Justin Trudeau and Bill Morneau aware of these "details" when they released the Proposals in July 18, or were they in a rush to go on their summer vacations?

Family Business Owners vs. Government Bureaucrats, who is treated more "Fair"?

The Proposals target three areas: income splitting, reinvesting family business profits for retirement savings, and capital gains from family businesses.

Not surprisingly, the Discussion Paper uses self-serving examples to justify the changes. We will use less self-serving examples and will contrast their impacts between two neighbours, Mr. and Mrs. Retailer, and Mr. and Mrs. Government Bureaucrat working at the Department of Finance.

Mr. and Mrs. Retailer are not rich. They own a retail store in a private corporation in Ottawa which employees other Canadians. Mr. Retailer works all the time in the business; Mrs. Retailer stays at home and looks after their 3 minor children. Before paying themselves anything, we will assume their corporation makes $220,000 in net income. Mr. Retailer pays himself a salary of $110,000 and pays Mrs. Retailer a dividend of the remainder after paying applicable corporate income taxes.

As a comparison, Mr. and Mrs. Bureaucrat work in Ottawa with the Department of Finance, both make $110,000 in salary ($220,000 in total household income), lots of paid vacation and banked sick time (Mr. and Mrs. Retailer get none), and both have a taxpayer funded, risk free defined benefit pension plan which, as per the Canadian Federation of Independent Business, they contribute to about 50% of its estimated costs (and prior to 2017, only about 37%), with the balance paid for by taxpayers, including Mr. and Mrs. Retailer.

Income Splitting Attack – Top Rate Tax and Retroactive Tax Effect

There are numerous complex and punitive attacks under the income splitting Proposals, but the most common attack will be on the spouses and common law partners of active family business owners who are not paying their "fair share".

Prior to the Proposals, the families of Mr. and Mrs. Retailer and Mr. and Mrs. Bureaucrat would have similar after tax family incomes on their similar before tax family incomes. The Proposals change that result. Under the Proposals, all of Mrs. Retailer's dividend would be taxed at the top marginal rate and will result in their family paying more than $10,000 of additional tax per annum versus Mr. and Mrs. Bureaucrat's family. Is this fair? It appears this Government thinks so. Ironically, the Discussion Paper refers to a "gender based analysis"; the value of a spouse or partner who stays at home to care for the children (usually the female) to support the efforts of the active spouse or partner in the family business (usually the male) receives zero recognition under the Proposals.

The Proposals are retroactive in effect. They not only apply the punitive tax rate to future earnings of the family business but also past retained profits in the family business. If Mr. Retailer retires in 2018 and wants to pay a dividend to Mrs. Retailer out of retained profits during their retirement years which were earned over a period of prior decades prior to the Proposals; the punitive top rate on the dividend would continue apply on that income also, an indirect way of imposing a retroactive tax on earnings retained in a corporation under a different set of rules and retirement planning expectations! Nice.

However, as it relates to the pensions of Mr. and Mrs. Bureaucrat, they continue to be allowed to income split with each other if one of them had higher pension income than the other or none. No proposed changes here – nothing at all. Self-serving, "selective fairness" is not fairness at all.

If this Government was truly sincere in its confessed aim in "making sure that we all pay our fair share of taxes – with no exceptions" the Proposals would level the playing field for all taxpayers by, for example, allowing all taxpayers, business owners or employees, the choice to file joint tax returns with their spouses or common law partners thereby availing the tax benefit for all instead of selectively taking it away for some and letting it remain for others.

Other nations take this approach, such as the United States; this respects couples' individual choices and allows for joint tax returns, rather than imposing costs for departing from implicit Government ideologies.

Retirement Savings Attack – Tax Rates > 70%

Mr. and Mrs. Retailer do not have the guaranteed and generous Government pension plan of Mr. and Mrs. Bureaucrat. Like many owners of family businesses, they compensate by risking a portion of their business after tax profits to earn non business income to fund their retirements. However, there is a significant cost to doing so; income earned on non-business income is taxed at an ultimate higher rate (generally over 50%) than if earned directly.

By way of contrast, those non business earnings are at risk, not guaranteed, and do not accumulate tax free as in the case of the pensions of Mr. and Mrs. Bureaucrat. Moreover, 50% or more of the ultimate payouts from the corporation of Mr. and Mrs. Retailer are not subsidized by the taxpayers of Canada, as in the case of Mr. and Mrs. Bureaucrat.

While nowhere near as advantageous as Mr. and Mrs. Bureaucrat's pensions, the Proposals attack the perceived unfair advantage that these corporations have because they start with higher amounts to invest because of lower corporate tax rates on business income versus if it was earned personally.

Unfortunately, the concept of corporate tax integration, including tax rates of over 50% on investment income, is not understood by the general population and the Government has decided to take advantage of this misinformation to squash the modest advantage of using owning a private corporation as a substitute pension vehicle. For whatever reason, a 50% or more tax rate is not enough and the Proposals would result in effective taxes in well in excess of 70% on such earnings. Is that fair? What rational person would ever invest in those circumstances?

Implicit in applicable tax rates in well in excess of 70% under the Proposals, do our provincial and federal Governments think they are far more entitled to income than those who worked and earned it?

In this toxic environment, the Proposals will drive away significant investment by private corporations, where that capital is becoming increasingly scarce because of the growing exodus of foreign capital, and will result in harmful, unintended consequences to the Canadian economy.

Capital Gains Attack - Double Tax with a Retroactive Tax Effect

Canadian taxpayers have witnessed dramatic income tax increases over the past few years. For example, in Alberta the top marginal tax rate has increased from 39% to 48% in just a couple of years. However, with a 50% inclusion rate, capital gain tax rate increases have been more insulated from other tax increases, including on dividends.

The Proposals seek to eliminate opportunities to benefit from this lower tax rate, whether intentionally or unintentionally (including due to ridiculously complex and overly broad changes to the intercorporate dividend rules by the Department of Finance) in a private corporation context. The Proposals will impose a double tax in such circumstances, and seek to impose retroactive tax on transactions that occurred in the past under a different set of rules!

Capital gains earned in the taxpayer funded pensions of Mr. and Mrs. Bureaucrat will continue to accumulate tax free.

What Can You Do?

This Government and the Bureaucrats at the Department of Finance appear to have forgotten that without a private sector (most of which is directly or indirectly attributable to family businesses) there is no money (other than borrowed money through deficit spending) to pay for the Government and its public sector, including the salaries and pensions of Mr. and Mrs. Bureaucrat.

This Government has an opportunity to make meaningful, long term positive changes to address tax policy concerns and improve economic competitiveness; however these fundamentally flawed Proposals with a disingenuous 75 day “consultation” process started during the middle of the summer is not going to make the cut.

We need to be very concerned about the destructive results of the Proposals and emphatically and forcefully inform our Government representatives and leaders, especially the Department of Finance (fin.consultation.fin@canada.ca), Justin Trudeau (justin.trudeau@parl.gc.ca) and Bill Morneau (Bill.Morneau@parl.gc.ca) of our concerns.

Hopefully goodwill and common sense will prevail.