Re: Consultation on Tax Planning Using Private Corporations

September 27, 2017

Dear Minister Morneau,

On July 18, 2017, your Liberal government introduced substantial and complex proposed changes to Canadian tax law. Where some are much needed they are unfortunately too limited in scope, and where others are over-broad, they risk punishing small and medium sized enterprises. I hope that you’ll consider broadening the scope of your reforms, providing targeted relief for small businesses and farmers, and going after stagnant and stashed coffers of large corporations.

The 2015 Liberal platform promised to end unfair loopholes for the wealthy, but it focused on the Universal Child Care Benefit, Income Splitting, and the income tax rate. The three changes proposed by the government in this package of amendments - income sprinkling, passive income and capital gains - were previously announced in Budget 2017, yet were not included in your government’s spring budget implementation act. Despite being proposed in the budget in March, the consultation was not opened on the measures until the middle of the summer, and even then, only for 75 days. This continues a worrying trend of your government (e.g.: Electoral Reform, Environmental Assessment legislation) to bury unpopular or otherwise undesirable consultations in the middle of the summer. Whether unintentional or deliberately strategic, the outcome is the same: a less successful and engaging consultation exercise.

On the other hand, I believe Finance Canada has set a good precedent by directly releasing draft legislation for (most) of these proposed measures. Had draft legislation guided the environmental assessment consultation it would have been far more effective. It’s a good practice that allows stakeholders, opposition members and the public to get a better grasp of the proposed measures. Despite the Conservatives, and others, efforts to simplify the conversation, the amount of detail in draft legislation forces the media and others to take a multi-dimensional
approach. In a time of fake news and increasingly aggressive partisan chicanery, having a surfeit of information ensures clear signals to the public and stakeholders about policy intent and gives the media a foothold to provide thoughtful, timely analysis.

**Income Sprinkling**

This is perhaps the clearest form of tax manipulation that the government cites, and seems a worthwhile pursuit for Finance Canada. The sum total that might be recouped however is quite small, approximately $250 million in additional revenues for the government. Certain forms of income sprinkling, particularly upon considering comparisons between salaried and incorporated single-family businesses, may justify government action. It's important to note that while this practice is perceived by many as unfair, it is not illegal, and those that engage in it do not do so in violation of Canadian law. It is possible to engage with these Canadians in a non-divisive manner, simply making the case that while this advantage was available to them in times of high tax rates, it’s no longer necessary in a low tax environment. Tax measures must be responsive to professionals who have used income sprinkling in making childcare arrangements. An adequate phase-in period will reduce hardships for people with young children who are not abusing the system.

Which brings us to what the government could offer as a carrot to justify cracking down on those who sprinkle their income within their family. Every party in the 2015 election, including the Liberals, agreed to lower the small business tax rate. And to do so in conjunction with the elimination of income sprinkling was the plan laid out in the Liberal platform. Some are suggesting that you may in fact be exploring pairing these two reforms. I hope you do. It sends a clear message: our aim is to resolve inequities in the small business tax framework, not tax small businesses more. In addition, I support a longer term review of the structure of corporate taxes, not just the tax rate. Some European countries have successfully implemented a reform that changes the Corporate Income Tax (CIT) into a “rent” tax, so that the tax cannot be said to act as a disincentive to investment and innovation. Among other things, this Allowance for Corporate Equity tax (ACE) enables firms to deduct the cost of borrowing and equity for their own investment.

Finally, the ‘reasonableness’ test that your government proposes for determining the legitimacy of dividend partners must be allowed to be studied by Parliament with caution. These rules will make small businesses feel as though they are under the microscope of the Canada Revenue Agency, and should be, once decided upon, made clear through a publicly financed education campaign. This will ensure the new rules are clear to everyone and avoid any perception of arbitrariness.

**Passive Income**

Corporations are not all equally worthy of Finance Canada’s extensive scrutiny. Yes, the government has seemingly identified a wealth of corporate money that is stagnant and being taxed at a lower rate. By taxing passive incomes at a higher rate, the government estimates that
given there was $27 billion in passive income distributed from private corporations a year as per 2015, there exists a substantial amount of potential tax revenue. I agree that that income is not currently being taxed appropriately, and some amount of that should justly be in government coffers. However there are some legitimate concerns that the passive incomes targeted here are in fact intended for use by many doctors and other small business as retirement savings plans. While this may not be the government’s preferred form of retirement investment vehicle, the reality is that it is being used that way. Any changes the government makes that impact retirement savings for Canadians who own small businesses should be made with great care taken to ensuring there are no unintended consequences. There must be more consultation. But there is also a much bigger fish to fry.

From the 1970s onward Canada slowly but surely lowered its income tax rate on large corporations in response to growing neoliberal pressures. One of your predecessors, Paul Martin, drastically cut the income tax on large corporations by six percentage points in three years during the course of his tenure. A global recession and a near decade of Harper’s government led to the further reduction of corporate tax income even lower. The reasoning behind such reductions was that corporations would use the extra cash to create jobs. The economic experiment lowering corporate taxes to create jobs is not proving to be money well spent. In the words of Mark Carney, former Governor of the Bank of Canada, the money that would have gone to pay for critical infrastructure, veterans’ benefits, and environmental research is “dead money.” It has not created jobs. It is sloshing around in the bank accounts of Canada’s biggest corporations.

As of 2015, it approached $700 billion – equaled to then 35% of Canada’s GDP. The federal personal income tax for top earners is 29 per cent – almost double the corporate income tax rate, now. Forty years ago, the share of personal income tax revenue in the federal government’s total revenue was 30 per cent; it was almost 50 per cent in 2013. But the share of corporate income tax has dropped from 20 per cent to 13.6 per cent today. Successive governments have systematically shifted the corporate tax burden to the middle class.

In 2013/14, the federal government collected $34.6 billion in corporate income tax. If our rate were 30 per cent (still 5 per cent lower than the U.S.), the federal coffer would have collected an additional $30 billion, substantially more than the government could expect from raising rates on passive income. This is money that could be used on health care, child care, senior care, veteran support, advance education, job training, retirement, environment, social housing, infrastructure, and the list goes on.

I support raising taxes on large corporations gradually, from the current level of 15% back to the level set in 2009 – 19.5%. We are well aware of the familiar argument that higher corporate taxes are inevitably passed on to consumers via increased prices for goods and services. However, in light of the evidence of hoards of cash accumulated by corporations after the financial crash of 2008, then used too often for mergers or to buy back shares which benefitted executive bonuses rather than being spent on employment and increasing productivity, this rings hollow. Raising the corporate tax rate to 19% would still leave some $595 billion in corporate coffers. (It is estimated that each percentage point increase in the federal corporate tax rate raises $1.5 billion in revenue.)
I believe the government would be best served by going after the corporate tax rate than implementing a rule that would potentially have unintended consequences. That said, if you can show that doctors and small businesses that have passive incomes invested in their corporations as retirement savings vehicles will not be unduly harmed by their plan, you would be well served to demonstrate this to parliamentarians during the legislative process. As this reform has no corresponding proposed legislative format, I look forward to seeing what Finance Canada tables in legislation this fall before Parliament.

**Capital Gains**

I generally support the idea of reform that seeks to harmonize the tax rates that apply to corporate surplus, however I am concerned about impact to the inter generational business transfer provisions on farmers and other small business owners. Farmers are concerned that your proposals make it easier to pass their farms onto unrelated buyers than their heirs. As stated above with respect to passive income, where Canadians retirement security is at stake, legislators must tread with great caution. The changes to Section 84.1 that apply immediately is throwing family business retirement and succession planning into chaos and has business owners struggling to chart a path forward. It might be beneficial for the government to pursue extending the ‘special election’ period that may allow for more farmers the option to cash out on their retirement savings. It would also communicate to farmers and other small business owners that the government isn’t looking for a simple cash grab, but rather levelling the playing field and attempting to secure tax equity.

I am disappointed the government has not placed more emphasis on pursuing the stock option deduction loophole. According to the Canadian Centre for Policy Alternatives, the employee stock option deduction alone costs the government approximately $740 million per year. They also conclude that the loophole benefits not merely those in the top decile of Canadian society, but that a shocking 100% of the benefits go to the richest 1%. This is, on its face, unacceptable. There are reasonable concerns about the impact that closing the loophole will have on the start-up industry, especially the tech sector which is an important source of jobs and growth for the Canadian economy. But there are many policy solutions that could balance the needs of growing businesses with the desire of many Canadians to see more tax fairness. The government should consider these, and the tech sector particularly, as it proceeds implementing these changes. However, I would also hope that the government would more aggressively pursue closing loopholes on offshore tax havens estimated to be sheltering at least $12 billion from Canadian tax authorities.

**Ambitious, daring reform**

I believe that taxation should be fair, efficient and effective. Canada has long recognized the importance of small and medium sized enterprises to our economy. While I support some of the reforms your government proposes in your consultation, I can’t help but expect more. A more holistic approach toward creating opportunities for SMEs to thrive in our economy. More attention to the billions in stagnant accounts, accumulated due to inconceivably low corporate
tax rates. More aggressive tactics toward exposing offshore tax havens. And the time is coming to revisit the tax code completely, with the aim of root and branch reform that simplifies its burden on both individuals and businesses.

I would also repeat my recommendation from Question Period on September 25th: a phase-in of these changes and a fair grandfather clause would go a long way to showing Canadians that these reforms are, in fact, seeking tax fairness.

I truly appreciate your openness to comments. I hope that Finance Canada fully considers the participation and comments submitted by so many engaged Canadians. I look forward to seeing legislation on these changes this fall before Parliament. I hope they receive a full and fair airing of the issues, in a separate piece of legislation, that will not be time allocated.

Sincerely,

Elizabeth May, O.C.
Member of Parliament
Saanich-Gulf Islands
Leader of the Green Party of Canada