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INVESTMENT INDUSTRY ASSOCIATION OF CANADA
ASSOCIATION CANADIENNE DU COMMERCE DES VALEURS MOBILIÈRES

LETTER FROM THE PRESIDENT

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Taxation of Passive Investment Income: Private corporation tax proposals could make financing conditions worse for small business

HIGHLIGHTS:

The federal government has remedied several concerns related to the taxation of passive income earned by small businesses. However, the allowable threshold of $50,000 in passive income is not grandfathered, nor adjusted for the rate of inflation. Further, the new rules will add to the administrative burden of small firms by requiring the tracking of eligible and non-eligible dividend flows in two separate accounts for tax compliance purposes.

Nearly 50,000 private corporations with significant pools of passive income, and holdings of investment assets, will be negatively affected by the proposed tax rules. Many of these businesses are actively involved in the angel financing networks across the country, providing significant equity capital and merchant banking services to emerging and growing small businesses. The proposed tax increase on dividends paid from passive income will discourage this financing activity.

Last summer, the federal government announced a series of tax proposals aimed at making private corporations "pay their fair share of tax". At issue is the tax treatment of passive investment income in Canadian-controlled private corporations (CCPCs) and so-called "income sprinkling". After a contentious consultation process, a revised version of the new rules came forward in the February 2018 Budget. The reaction to the budget proposals has been relatively muted, and, on balance, positive, largely because the proposals shelter small businesses qualifying for the small businesses deduction from the proposed increase in the effective tax rate on passive income, and because the government announced plans to lower the small business tax rate to nine per cent by 2019.

While the new rules for taxing passive income are much simpler and will impact fewer businesses compared to the original proposals, roughly 50,000 large private corporations are negatively impacted by the proposals.

The federal government expects to raise $925 million per year by 2022–23, or $3.4 billion over five years, from the proposed tax measures. This means private corporations will have $3.4 billion less to weather economic downturns, purchase equipment, invest in property or land, expand their operations, or invest in new and emerging businesses.

The sectors most impacted—finance and insurance, real estate, and management of companies and enterprises—likely undertake advisory and financing activities in the small and mid-sized business sector, providing an alternative to public venture capital markets and private equity markets, and play a key role in promoting growth and expansion of small and mid-sized businesses in Canada. The proposed tax measures will constrict the already scarce flow of capital to new and emerging enterprises. Moreover, the new rules impose a greater administrative and compliance burden on businesses.

THE GOVERNMENT'S TAX PROPOSALS

First, the $500,000 small business deduction will be reduced by $5 for every $1 of passive income earned in excess of $50,000 in the taxation year. The availability of the small business deduction, and hence the preferred small business tax rate (10 per cent, at present) would be completely eliminated once passive income reaches $150,000 in a year. Small businesses with more than $150,000 in passive investment income will pay the higher general corporate income tax rate (15%) on their active business income.

Further, while the government pledged last fall that all past investments and the income earned from these investments would be grandfathered, this has turned out not to be the case. Businesses that had built a significant pool of passive investments will be negatively affected by losing access to the small business tax rate. Moreover, the $50,000 and $150,000 exemption limits are not indexed to inflation, meaning that over time, more and more small businesses will subject to bracket creep on the taxation of their passive investment income.

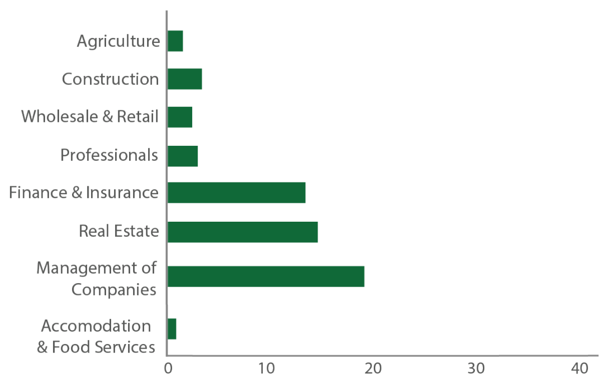
Second, large CCPCs will have access to refundable taxes only when a they pay non-eligible dividends. However, these companies almost never pay non-eligible dividends, so the tax refund is generally non-applicable. Before the budget measures were introduced, this refund applied to all private corporations, whether the corporation paid out an "eligible" or "non-eligible" dividend.

Third, the so-called "income sprinkling" proposals will have significant implications for businesses that distribute income to multiple individuals, including co-owners and family members. A business must now meet a "reasonableness test" to prove a family member has made a meaningful contribution to the business, in terms of work performed, property contributed, and risks assumed. This is highly subjective and places a costly administrative burden on businesses. Without clarification, what is "reasonable" will be decided over time by the CRA and the courts.

FIRMS MOST IMPACTED

Research conducted by the Office of the Parliamentary Budget Officer (PBO) indicates that CCPCs with large amounts of passive investment income are disproportionately large in size. Roughly one-third of passive investment income is earned by firms with more than $15 million in taxable capital. Three sectors combined—finance and insurance, real estate, and management of companies and enterprises—earned close to 50 per cent of all taxable passive income. Evidence suggests these CCPCs, impacted by the tax measures, are deeply integrated into the small and mid-sized business sector, engaged in debt and equity financing, strategic corporate advisory services, and merchant banking. As independent corporations and holdco structures, they take ownership positions in active businesses for long-term investment and to restructure businesses for eventual resale. The estimated large holdings of passive assets (some $250 billion in total) and annual passive investment income earnings (estimated at $27 billion), suggests these CCPCs have a sweeping impact on the small business sector.

CCPCs, Share of Total Taxable Passive Income by Industry (%)



Source: Parliamentary Budget Officer

The government's proposed measures will discourage the specialized large private corporations from undertaking advisory and financing activities in the small business sector. It is likely that affiliates of these firms will shift operations to the United States to take advantage of more favourable tax treatment. This shift of advice and capital south of the border will be a significant loss for the Canadian small business sector and the Canadian economy.

IIAC'S RECOMMENDATIONS

On October 24, 2017, I testified before the Standing Senate Committee on National Finance as it undertook its study of the proposed changes to the *Income Tax Act* respecting the taxation of private corporations. At that time, I urged the government to take its tax proposals off the table, stressing the taxation of passive investment income in privately held Canadian companies has been well understood, fair and worked effectively for more than four decades. I added that the government's proposals introduce unneeded complexity, serious unintended consequences, and a disincentive to business investment and entrepreneurship in Canada.

The Committee on National Finance tabled its Report in December 2017, and agreed with the IIAC's position. It recommended that the Minister of Finance withdraw his proposed changes to the *Income Tax Act* respecting Canadian-controlled private corporations.

In the face of overwhelmingly negative feedback on its original proposals, the government brought forward a revised version of the rules in Budget 2018 and in Bill C-74, the *Budget Implementation Act, 2018*. The bill was read the second time in the House and referred to the House of Commons Standing Committee on Finance. On May 1, 2018 I testified before the Finance Committee, focusing my remarks on Part 1 of the Bill and, particularly, on the sections that pertain to passive investment income, the refundability of taxes on investment income, and income sprinkling.

I recommended the following:

That the federal government:

Re: Passive Investment Income

- Not proceed with the passive investment tax proposals.
- If determined to proceed:
    - Grandfather past investments, and the income earned from such investments.
    - Index the $50,000 and $150,000 exemption limits to inflation.
    - Monitor the impact of the new rules on business behaviour.

Re: Income Splitting

- Consider further amendments to the rules to provide greater clarity.
- Delay implementation to give businesses more time to prepare and comply with the new rules.

— An abbreviated article on this topic appeared in the Hill Times on May 21, 2018.

Yours sincerely,

Ian C. W. Russell, FCSI
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